AMENDED

INTERIM REPORT NO. 6

REGARDING THE SAN DIEGO CITY

EMPLOYEES' RETIREMENT SYSTEM FUNDING SCHEME

REPORT OF THE

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I.
INTRODUCTION

San Diego's pension funding crisis began on 21 June 1996, when the board of the City's pension system agreed to allow the City to reduce contributions to the plan below amounts needed to pay for benefits already granted. On 2 July 1996, then-San Diego Mayor Susan Golding and the City Council acquiesced in this plan. In order to induce pension officials to not require the City to meet its legal duty to fully fund existing pension benefits, the Mayor and City Council granted hundreds of millions of dollars of new benefits in violation of the liability limits of the State Constitution and the City Charter. These 1996 decisions set in motion the worst financial crisis in the history of the City of San Diego.

The elaborate scheme concocted by certain City officials was also aimed at concealing the depth of the funding crisis from San Diego taxpayers and the investors who bought the City's bonds. This scheme was carried out for seven years by City officials, who will be identified in this Sixth Interim Report of the San Diego City Attorney. Currently, the pension benefit liabilities of the pension fund exceed its assets by more than $1.7 billion dollars.

In this report the San Diego City Attorney concludes that substantial evidence exists that is consistent with a finding that, in 1996 and 1997, City and pension officials violated their fiduciary duty owed to the City of San Diego and the San Diego City Employees' Retirement System (SDCERS) in connection with the creation of a pension benefit and funding contract known Manager's Proposal 1 (MP-1).

There is also substantial evidence that these officials engaged in fraudulent and deceptive acts and practices in connection with the creation of hundreds of millions of dollars of pension benefits related to MP-1.

There is also substantial evidence that, in violation of Government Code § 1090, these officials held prohibited contractual interests in the pension benefits that they voted to create.

There is also substantial evidence that by offering to exchange and exchanging a thing of value with the pension board, these officials created, in MP-1, an illegal and unenforceable contract.

There is also substantial evidence that by creating and representing the terms of MP-1, then-City Manager Jack McGrory acted as a fiduciary to the City's pension plan participants and that by engaging in the acts and practices detailed in this report, he violated his fiduciary duty to those participants.

There is also substantial evidence that professionals providing expert services to both the City and the pension board members violated their duties of conduct and care in connection with the creation and implementation of MP-1.

There is also substantial evidence that in creating these unpaid-for pension benefits City and pension officials violated the liability limits of the City Charter and the State Constitution.

The legal remedies available to the City and the pension board will be discussed in detail in Interim Report No. 7.

II.

BACKGROUND

The San Diego City Attorney has issued five interim reports focusing on possible illegal acts by City officials in connection with the audit of the City's 2003 financial statement. The reports found as follows:

(1) In Interim Report No. 1 (January 14, 2005), regarding possible abuse, fraud, and illegal acts by San Diego City officials and employees, the City Attorney released evidence that the 2002 final report of the Mayor's Blue Ribbon Committee on City of San Diego Finances understated the severity of the City's pension fund liability by 318% or $215 million.

(2) In Interim Report No. 2 (February 2, 2005), regarding possible abuse, fraud, and illegal acts by San Diego City officials, the City Attorney revealed substantial evidence consistent with a finding that the Mayor and Council authorized the issuance of certain City bond offerings and related disclosure documents that they knew to be false.

(3) In Interim Report No. 3 (April 9, 2005), regarding violations of State and local laws related to the SDCERS Pension Fund, the City Attorney concluded that City officials violated the California Constitution, State law, the San Diego City Charter, and the San Diego Municipal Code in causing the underfunding of the San Diego City Employees' Retirement System.

(4) In Interim Report No. 4 (May 9, 2005), regarding additional funding for outside professionals reviewing alleged illegal acts, the City Attorney questioned whether the Outside Professionals' Audit Committee could finish its work in an economical and timely manner and recommended that the Council not approve any additional funds for the Committee until a complete review of its scope of work had been conducted.

(5) In Interim Report No. 5 (May 18, 2005), regarding the legal status of the elected officers' retirement program, the City Attorney determined that the City Council violated the Charter's pension vesting rules when members passed an ordinance that granted benefits to elected officials who had not served for 10 years and who had not reached age 62.

III.

DISCUSSION OF FACTS

A. INTRODUCTION

On 21 June 1996, the San Diego employees' pension plan board of trustees adopted a radical benefit funding proposal made by then-City Manager Jack McGrory. The McGrory proposal was designed to relieve the City of its legal duty to pay into its pension plan the amounts needed to ensure that benefits would be paid promptly.[1] In exchange, City officials agreed to create hundreds of millions of dollars of new benefits that had no funding source.[2] This reduced-funding-for-increased-benefits agreement is referred to as Managers' Proposal No. 1 (MP1).

B. MCGRORY PROPOSAL: EXCHANGE VIOLATION OF CHARTER EXPENDITURE CONTROL LIMITS FOR VIOLATION OF STATE CONSTITUTIONAL PROMPT PAYMENT OF BENEFITS FUNDING REQUIREMENT

City officials, pension trustees, and plan participants must comply with the expenditure control provisions contained in the San Diego Charter.[3] Pension board members administering the City's pension must require the City to pay for legally created benefits so that these benefits can be paid to retirees promptly.[4] These two legal mandates frame and limit the City's ability to create pension benefits.

In 1996, City and pension officials acted outside these mandates by entering into MP-1. Under MP-1, these officials, led by McGrory and pension administrator Lawrence Grissom, agreed to increase pension benefits and to decrease pension benefit funding. This agreement, which was violative of both the City Charter and the State Constitution, when combined with a similar agreement that City officials entered into in 2002, has resulted in the worst financial crisis in modern San Diego history.

San Diego Charter § 99 prohibits the City from incurring "any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year unless the qualified electors of the City, voting at an election to be held for that purpose, have indicated their assent … ."[5] California State Constitution

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[1] Cal. Const. art. XVI, § 17(a).

[2] See 23 July 1996 Lexin Memorandum and City Attorney Interim Reports Nos 1-5; see City Attorney's Website.

[3] San Diego Charter § 99.

[4] Cal. Const. Art. XVI, § 17(a). See n. 1.

[5] San Diego Charter § 99. See n. 3.

Article XVI, § 17(a) requires that the City's pension plan be administered "in a manner that will assure prompt delivery of benefits" to the participants and their beneficiaries.[6]

C. ORIGINS OF MP-1

MP-1 originated in a series of meetings among Mr. McGrory, Mr. Grissom, and pension board president Keith Enerson. A "Draft" and "Confidential" 29 February 1996 memorandum from Mr. McGrory to "Distribution" provided an "outline of the package we discussed with Keith [Enerson] and Larry [Grissom]."[7] This outline detailed a proposal that the City's pension plan funding level would not be set by actuarial determination[8] but instead would be limited to "the lower bifurcated rate in FY 96."[9] In exchange for this limitation of the City's pension contribution, benefits were to be increased:

> 3. WE PROVIDE THE ½ AND ¾ EMPLOYEE BENEFIT THAT WAS AT COUNCIL
> 4. WE ELIMINATE THE DISABILITY INCOME OFFSET.
> ***
> 9.WE PROVIDE A 3 YEAR OPEN ENDED BUY BACK TO BE PAID, BOTH EMPLOYEEE AND CITY CONTRIBUTIONS, BY THE EMPLOYEE-THIS WOULD BE A ONE TIME BENEFIT BUT COULD BE PAID BY ALLOWING EMPLOYEES TO TRADE SOME % OF THEIR ANNUAL LEAVE AT TERMINATION.

Obviously, in 1996, City officials were focused on increasing the money that they could take out of the pension plan beyond those amounts diverted from "surplus earnings." Their proposal was to continue to take money from the pension fund and beginning in 1997, to put less in by underfunding the pension benefits that they created. On 1 March 1996, pension administrator Mr. Grissom wrote a more extensive memorandum regarding a 26 February 1996 meeting that he had attended with Mr. McGrory and Mr. Enerson. In his memorandum Mr. Grissom acknowledges that the heart of their negotiations was the City's existing practice of diverting money from the pension plan to pay for non-pension purposes. This acknowledgement demonstrates that City officials had previously engaged in an unlawful practice of diverting funds from the pension system.[10]

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[6] Cal. Const Art. XVI, § 17(a). See n. 1.

[7] February 1996 Jack McGrory memorandum to "Distribution."

[8] San Diego Charter §§ 142 and 143 and Article XVI § 17(a) of the California Constitution require that the City's pension fund payment be determined by an actuary; see fn. 1.

[9] 29 February 1996 Jack McGrory memorandum to "Distribution;" see n. 7.

[10] See 16 September 2004 Report on Investigation the City of San Diego, California's Disclosures of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code pp. 31-34 (16 September 2004 Report). The money diverted from the pension funds were euphemistically referred to as "surplus

Mr. Grissom began his 1 March 1996 memorandum by alluding to the central role played by "undistributed earnings." He then went on to describe the "package" that would allow the City to put less money into the system in exchange for creating new benefits. "I will start with reserve crediting of undistributed income since the rest of the package flows out of this."[11] Mr. Grissom explained that the new unfunded benefits would solve the "perception" that the pension board was "giving the City a lot of money":

> What follows is a proposal for implementing the package that you Jack and I discussed on February 26. It is necessarily a little rough due to the time of constraints. I will start with reserve crediting of undistributed income since the rest of the package flows out of this.
> ***
> 1. Perception. It looks like the Board is "giving" the City a lot of money. This is, frankly, a political and negotiation issue. The negative perception should be at least partially offset by increasing benefits as discussed below.[12]

Mr. Grissom was understandably skeptical about the reaction of outside legal counsel to a package in which unfunded benefits would be exchanged for lowered funding. He knew that the plan would have to be carefully framed in order to get it past outside counsel:

> 2. Outside counsel. I have no idea whatsoever how outside counsel will react to this plan. We should consider this carefully and thoroughly strategize out [sic] approach.

Mr. Grissom brought home in no uncertain terms that funds diverted from surplus earnings into reserves directly increased the pension fund's unfunded liability. He explained the ratio between increases in the system's unfunded liability due to diversions of pension funds into reserve accounts and increases in the City's contribution rate into the system to make up for the earlier diversions:

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earnings" or "undistributed income." These diverted pension funds were "transferred" to "reserves." Funds held by the pension plan and all earnings thereon are required to be used so that benefits can be delivered promptly to plan participants. Diversions of surplus earnings are unlawful under the State Constitution and fiduciary laws. In *Board of Administration v. Wilson*, 52 Cal. App. 3d 1109, 1131-1137 (1997), the court held that vested state employee members of CalPERS have a contractual right to an actuarially sound retirement system; see City of San Diego Website.

[11] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 2.

[12] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 2. See n. 11.

3. Holding Stabilization Reserve outside valuation assets. This means that Rick does not count that amount as assets in the actuarial valuation. The net effect is to increase the System's unfunded liability. For each $10 million in unfunded liability, the City contribution rate will increase approximately 0.13% all else being equal.

Although Mr. Grissom suggested that the diversions and the related increases in the City's future contribution rate be "capped" at $75 million, he admitted that predicting the effect of the "package" on the level of future underfunding was "nearly impossible," thus undermining the parties' ability to set any caps on diversions or on the related future rate increases:

> This is why I recommended capping this reserve at $75 million, since that would mean an increase in the City Contribution rate of about 1%. Two factors mitigate the rate increase. First, while it is nearly impossible to predict with any accuracy, I don't think the reserve will get that high. Second, it is a question of trade-offs. At current payroll levels, 1% amounts to between $4.5 and $4.0 million, which is the maximum only if the reserve reaches it cap.[13]

In his 1 March 1996 memorandum, Mr. Grissom also estimated that under the MP-1 package, a "stabilization" of the City's rate of contribution into the pension system would be set in order to reduce the City's annual payment by at least $5 million per year: "The City will be getting a reduction of at least $5 million annually on its contribution cost for the next five years."[14]

According to his memorandum, pension system actuary Rick Roeder had already signaled that he was comfortable with the "concept," including the increase of diverted funds into the reserve accounts: "I have also discussed this concept with Rick [Roeder] and he is comfortable from an actuarial standpoint with this reserve."[15]

Mr. Grissom described in detail the predicament faced by the pension system that was caused both by past efforts to reduce the contribution rate that the City had to pay into the system and by the City's use of pension funds to pay for non-pension benefits. One factor in the predicament was the decision to use alternative methods for measuring the amounts due the pension fund from the City. Prior to 1996, the City and pension system officials had agreed to shift from the EAN method to the PUC computation

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[13] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" pp. 2-3. See n. 11.

[14] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 3. See n. 11.

[15] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 3. See n. 11.

method with the expectation that rates would be reduced. However, as Mr. Grissom stated in his memorandum, the actual outcome varied from the predicted, leading him to conclude that the system should return to the EAN method:

> RATE STABILIZATION
>
> The central recommendation to this discussion is to change from PUB back to EAN effective July 1, 1996. Rick has indicated that the EAN rate for the FY95 valuation (effective July 1, 1996) would be approximately 10.2%. The PUC rate for the FY 95 valuation is 9.2%, or a difference of 1%. When the conversion was made for rates effective July 1, 1992, the difference was 2.77%.
>
> The analysis by the actuary of the time of conversion showed that PUC was cheaper in the beginning, but that, since PUC rates would increase slightly annual while EAN remains stable (all else being equal), the "lines will cross" around year 22 of a 30 year amortization period. The PUC rate will be higher than EAN at the end of 30 year amortization period. What has happened is that the gap has narrowed by 1.77% in only four years. If things keep going the way they have been, the lines will cross in the next 2 to 5 years, less than 10 years after implementation. At the end of the amortization period, PUC could logically be very significantly higher.[16]

The 1 March 1996 memorandum went on to describe the proposed "Implementation Plan," in which the City's contribution rates between fiscal year 1996 and fiscal year 2000 would be reduced below the actuarially required rate with a resultant temporary savings to the City of $45 million.[17] The Grissom memorandum then described the increased unfunded benefits that the City would agree to in order to offset the appearance that the pension system was "giving the City a lot of money":[18]

[16] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 3. See n. 11.

[17] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 4. See n. 11.

[18] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 2. See n. 11.

BENEFITS CHANGES

1. Elimination of the disability income offset. This is a win win. Since we are already increasing contributions to pay off the unfunded liability and we have established that any recovery under the presently structured plan will be minimal we are assuming 0 offset in our actuarial assumptions. This means that this is a cost free benefit.
2. Grant the Virginia Silverman purchase. Roll this into purchase of service changes described below.
3. Make pre 80 health insurance coverage a permanent benefit. Projected cost for FY 96 is $622,400. Cost will decline in the future assuming continuation of current level of benefit since this is a closed group. Cost is built in to projections of total health insurance benefit.
4. Double 13th check amount for pre 80 retirees. Projected cost for FY 97 (FY 96 has already been paid) is $571,000 based on those with received a 13th check for FY 96. Actual cost will be slightly less because this is a closed group and some will be gone by October.
5. Change purchase of service. My recommendation is as follows:
   a. Keep refunds, probationary period, 1981 Plan waiting period, and Military & Veterans Code required military service intact.
   b. Eliminate all other existing categories of purchase.
   c. Replace with a program allowing any member to purchase up to 5 (3?) years of additional service any time or at retirement; Purchase cost to be calculated based on individual contribution rate including offset, City contribution rate, and current salary.
   d. Purchase at time of retirement can be made using some form of negotiated credits for unused annual leave. ***
6. Increase general member formula.[19]

The purchase-of-service-credit benefit increase drew special mention from Mr. Grissom, who called it a "potentially great benefit." Although he described problems associated with the amount a member would be allowed to pay, he dismissed all impediments and indicated that he already had outside legal counsel Bob Blum and pension system actuary Rick Roeder working on the problems: "There are always solutions. I have talked to Bob Blum and Rick [Roeder] and we are working on a variety of ideas . . . [w]orking with Rick [Roeder] on design and costs. I may not have time to offer a good solution by March 5, but will shortly thereafter."[20]

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[19] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 5. See n. 11.

[20] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 6. See n. 11.

According to Mr. Grissom, Mr. McGrory agreed to "go to the Council and recommend that they direct the Manager and Board to study and report back" with regard to certain aspects of the plan. Mr. Grissom then ends his memorandum with a summary of the MP-1 package:

> This is a good plan. It gives the city nearly 445 million of rate relief over the next 5 years. . . . It provides an equitable distribution of earnings while providing a measure of protection. It solves some gnawing administrative problems. It should provide a sufficient ratio of increased benefits and costs to satisfy fiduciary counsel. It does not give safety members and retirees, particularly thereafter, all that they might want, but it does represent a significant improvement.[21]

On 19 March 1996, 18 days after Mr. Grissom recorded Mr. McGrory's agreement to take parts of the proposed MP-1 package to the City Council, the Council held a closed session on meet and confer issues.[22] The docket for the meeting reflects a closed session for the purpose of labor negotiations: "Conference with Labor Negotiator, Pursuant to Government Code § 54957.6." The City's negotiators were identified as Jack McGrory, Bruce Herring, Cathy Lexin, and Bill Lopez. Three of the City's four unions, AFSME Local 127, Firefighters Local 145, and the San Diego Police Officers Association, were also identified.[23] The minutes, which indicate that Mr. McGrory and Mr. Herring were present, list the eighth item on the agenda as "Meet and Confer."[24] As reflected in the minutes, the City Clerk employee keeping the minutes left the room when the meet and confer issue was reached: "Recorder Skelley left at 9:57 a.m. and the Council continued in Closed Session for meet and confer until 10:02 a.m."[25]

On 28 March 1996, Bruce Herring faxed a version of the MP-1 package ("draft 1996 SDCERS Plan Revision Outline") to attorney Jeffrey S. Leavitt, a partner in the Jones, Day Reavis & Pogue law firm.[26] The proposal was the result of discussions between the plan administrator of the San Diego City Employees' Retirement System

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[21] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 7. See n. 11.

[22] 1 March 1996 San Diego City Employees' Retirement System Memorandum from Larry Grissom to Keith Enerson regarding "Proposed Retirement Package" p. 7. See n. 11.

[23] 19 March 1996 San Diego City Council Closed Session Docket.

[24] 19 March 1996 San Diego City Council Closed Session Agenda.

[25] 19 March 1996 San Diego City Council Closed Session Minutes p. 3.

[26] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring re: "Fiduciary Aspects of Plan Revisions." A 2 April 1996 letter from Jeffrey S. Leavitt to Bruce Herring confirms the City's retention of the Jones Day law firm "regarding the fiduciary and federal tax implications of the proposed revisions to benefits for City employees under the San Diego City Employees' Retirement System."

(SDCERS or the System) and the City Manager.[27] At the time this proposal was "being discussed with labor organizations representing the City's employees as part of the [then] current meet and confer process."[28]

The proposal as of 28 March 1996, was described by the City's outside counsel as follows: First, it included various changes in benefits, most of which constituted benefit increases.[29] Second, it contained a change in the method of providing medical benefits.[30] Third, the final portion of the proposal concerned rate stabilization and changes to reserves.[31] The proposal also included a statement that there would be no changes in actuarial assumptions or actuarial methodology that could conceivably effect contribution rates prior to July 1, 2000.[32] From the City's point of view, the rate stabilization and changes to reserves were the quid pro quo for the proposed benefit improvements.[33]

On the 9 April 1996 City Counsel closed session agenda, the fifth item was "Meet and Confer." Minutes of the session indicated that Mr. McGrory was present. They further indicated that at 9:55 a.m., the closed session discussion began again absent a City Clerk minute taker: "This portion of the Closed Session Meeting halted at 9:55 a.m. Council discussion followed pertaining to the Meet and Confer issues."[34]

An 11 April 1996 memorandum from Deputy City Attorney John M. Kaheny regarding "Closed Session Agenda Items for April 16, 1996" had recorded that labor negotiations were to take place at the 16 April 1996 closed session.[35] The memorandum identified the City's negotiators as Jack McGrory, Bruce Herring, Cathy Lexin, and Bill Lopez.

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[27] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring re: "Fiduciary Aspects of Plan Revisions" p. 1. See n. 26.

[28] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring re: "Fiduciary Aspects of Plan Revisions" p. 1. See n. 26.

[29] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring re: "Fiduciary Aspects of Plan Revisions" p. 4. See n. 26.

[30] The medical benefits issues are not discussed in this report.

[31] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring re: "Fiduciary Aspects of Plan Revisions" p. 5; see n. 26.

[32] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring re: "Fiduciary Aspects of Plan Revisions" p. 4; see n. 26.

[33] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring re: "Fiduciary Aspects of Plan Revisions" pp. 4-5; see n. 26.

[34] 9 April 1996 San Diego City Council Closed Session Minutes p. 3.

[35] 11 April 1996 Closed Session Item Memorandum from Deputy City Attorney John M. Kaheny to City Clerk p. 2.

The 16 April 1996 City Council closed session agenda indicated that the eighth item was "Meet and Confer."[36] Minutes of the session indicated that Mr. McGrory and Mr. Herring were present. They further indicated that at 10:17 a.m., the City Council's closed session halted and that Council continued with a discussion about meet and confer.[37] At 2:00 p.m., the Council reconvened to continue meet and confer discussions.[38] Again, apparently no City Clerk employee kept minutes of these discussions.

On 23 April 1996 San Diego City Attorney John Witt issued a report to the Board of Administration of the San Diego City Employees' Retirement System.[39] In the report City Attorney Witt recorded the fact that on 18 April 1996, pension administrator Lawrence Grissom told the pension board that they would convene in a special meeting on 30 April 1996. The purpose of the meeting was to discuss the MP-1 proposal offered by City Manager Jack McGrory.[40] City Attorney Witt indicated that he had read MP-1 and that it concerned "benefits improvements, contribution rates, and reserve accounting."[41] Mr. Witt went on to describe what he considered to be a personal conflict of interest and to state that he would not be advising the pension board on MP-1:

> I have reviewed the Manager's proposal. It concerns benefit improvements, contribution rates and reserve accounting. With my concurrence, the City Manager has retained the services of outside legal counsel to assist him with the fiduciary implications of this proposal. The City Manager has also retained the services of an outside actuary.
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> In accordance with Rule 7.20, Rules of the Retirement Board of Administration, I am also advising you to seek the services of outside fiduciary counsel to assist you in reviewing the Manager's proposal. In my view, this proposal raises important fiduciary considerations which must be fully examined as part of your decision-making process. I am uncomfortable in providing you this needed fiduciary guidance for several reasons.
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> First, I will be retiring after the conclusion of my present term in office. The Manager's proposal involves proposed benefit increases which

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[36] 16 April 1996 San Diego City Council Closed Session Agenda.

[37] 16 April 1996 San Diego City Council Closed Session Minutes p. 3.

[38] 16 April 1996 San Diego City Council Closed Session Minutes p. 3. See n. 37.

[39] 23 April 1996 City Attorney Report to the Board of Administration for the San Diego City Employees' Retirement System.

[40] 23 April 1996 City Attorney Report to the Board of Administration for the San Diego City Employees' Retirement System p. 1. See n. 39

[41] 23 April 1996 City Attorney Report to the Board of Administration for the San Diego City Employees' Retirement System, p. 1. See n. 39.

> substantially enhance my retirement benefits. Although, I realize that I do not have a legal conflict of interest, I am very concerned about the appearance of a conflict of interest. Second, the proposal addresses other significant benefit enhancements, future contribution rates, a change in the funding method (a return to EAN from PUC), and other changes with the Reserves maintained and administered by the Board. As both the legal advisor to the Board and the City Manager, my concern over the appearance of a conflict of interest in this sensitive and volatile area is exacerbated.

Mr. Witt then described the possibility of litigation between the pension board and the City Manager as an additional reason for his decision to withdraw from representation. This 23 April 1996 memorandum underscores the significant changes that were being considered by the Council, the City Manager, and the pension board. At this key point the City Attorney should have stepped forward and stopped the proposal to exchange the creation unfunded benefits for a reduction in the constitutionally mandated funding.

An 18 April 1996 memorandum regarding closed session items that was authored by Deputy City Attorney John M. Kaheny identified a conference with the City's labor negotiators as an item to be discussed at the 23 April 1996 closed session.[42] It also named the City's negotiators as Jack McGrory, Bruce Herring, Cathy Lexin, and Bill Lopez. The 23 April 1996 Closed Session Agenda identified "Meet and Confer" as the second of two items to be discussed.[43]

The 23 April 1996 closed session docket identified a conference with the City's labor negotiator as the second and last item to be discussed at the closed session on 23 April 1996. The City's negotiators were identified as Jack McGrory, Bruce Herring, Cathy Lexin, and Bill Lopez.[44] The minutes for the 23 April 1996 closed session indicate that the City Council continued with the meet and confer items until 10:00 a.m. The minutes reflect that Jack McGrory and Bruce Herring were in attendance at the closed session.[45] Again, apparently no City Clerk employee kept minutes of these meet and confer discussions.

The essential features of what was to become MP-1 were set forth in a draft "Concept Overview" prepared by Mr. McGrory and dated 29 April 1996. Stressing that "substantial financial implications to the City compel that certain actions occur in time

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[42] 18 April 1996 Closed Session Item Memorandum from Deputy City Attorney John M. Kaheny to City Clerk.

[43] 23 April 1996 San Diego City Council Closed Session Agenda.

[44] 23 April 1996 San Diego City Council Closed Session Docket.

[45] 23 April 1996 San Diego City Council Closed Session Minutes p. 1.

for Fiscal Year 1997 budget decisions,"[46] Mr. McGrory proposed reducing the City's contribution rate to a fixed amount below that required by actuarial computation. He did so despite the fact that the plan beneficiaries have a contractual right to an actuarially sound fund. *Claypool v. Wilson*, 4 Cal. App. 4th 646, 676 (1992). In addition under San Diego Charter § 143, the City is required to make pension plan contribution rates as set by an actuary.

The 29 April 1996 version of MP-1 represented a two-part increase in the pension deficit. First, there would be an increase in six pension benefits, the costs of which would be added to the long-term pension deficit. Second, there would be a significant reduction in the amount that the City would be required to pay into the pension system for benefits already adopted.[47] The combination of increased unpaid-for benefits and decreased contributions for benefits already created eventually led to the $1.7 billion deficit facing the pension system as of 15 June 2005.[48]

Two of the proposed benefits in the 29 April 1996 Concept Overview involved the purchase of service credits. Under this proposed program, all employees would be permitted to buy up to five years of service credits for "an amount, including interest, determined by the Board in such manner and at such time as the Board may by rule prescribe."[49] In addition those employees with 15 or more years of creditable service as of 1 July 1996, would be permitted to "purchase up to five (5) years of service . . . at a discounted rate subject to the individual employee's IRS 415 limitations."[50] The total costs of the proposed discount for the service credit program, which were not to exceed $6 million,[51] were to be paid from "surplus earnings."[52] The final version of MP-1, dated 23 July 1996, stated that employees were to pay "full cost" for the purchase of service credits.[53] The pension system's 2004 actuarial report shows that 2900 plan participants purchased over 13,000 years of service credits. The system actuary has

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[46] 29 April 1996 City Employees Retirement System "Concept Overview" p. 1-4.

[47] 29 April 1996 City Employees Retirement System "Concept Overview" p. 1. See n. 46

[48] Although the pension system actuarial report for the fiscal year ending 30 June 2004, estimated the pension deficit at $1.4 billion, work done by the City's outside auditor, KPMG, has caused the estimated shortfall to be put at closer to $1.7 billion.

[49] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 2. See n. 46.

[50] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 2; IRS Code § 415 provides for dollar limitations on benefits and contributions under qualified retirement plans. It also requires that the IRS Commissioner annually adjust these limits for cost of living increases. See n. 46.

[51] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 2; IRS Code § 415 provides for dollar limitations on benefits and contributions under qualified retirement plans. It also requires that the IRS Commissioner annually adjust these limits for cost of living increases. See n. 46.

[52] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 2. See n. 46.

[53] 23 July 1996 memorandum from Cathy Lexin to Larry Grissom p. 2, 6; see fn 2.

estimated that these 13,000 years of service credits were sold at a cost to the City of in excess of $100 million.[54]

Another benefit increase proposed in the 29 April 1996 Concept Overview was the Deferred Retirement Option Plan (DROP). Under the DROP program employees would receive their annual salary and their retirement benefit with 8% interest on the retirement portion of their DROP takings. The 29 April 1996 version of MP-1 provided that DROP "would have no cost impact to the City or CERS."[55] Employees could "participate in this program subject to management approval, and [could] be terminated by Management at the end of three (3) years."[56]

Contrary to the earlier assessment, it is now estimated that the DROP program does have a cost effect on CERS.[57] The power to terminate the program after three years, contained in the 29 April 1996 Concept Overview, was changed in the final version: "If the cost impact to the City or CERS is greater than the savings, the City agrees to meet and confer to impasse prior to imposing any changes in the DROP Plan."[58] Other benefit increases in the City Manager's 29 April 1996 Concept Overview included both increases in the percentage formula used to calculate general employees' per-year pension benefits and an increase for industrial disability. The costs of the increase in the former were to be paid "from any surplus undistributed excess earnings."[59] The creation of pension benefits with no or an inadequate funding source violated San Diego Charter § 99, the City's expenditure control provision that prohibits the incurring of "any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year" unless approved by the voters.[60]

While proposing to increase the pension deficit by creating new unpaid-for benefits, in the 29 April 1996 Concept Overview the City Manager also proposed an increase in the deficit that would result from decreasing the City's payments into the pension fund to amounts below those needed to pay for benefits already adopted. These decreased payments took two forms. The first proposed by Mr. McGrory was a reduction, beginning in fiscal year 1997, in the City's pension contribution rate. The second reduction was caused by diversions of pension funds already in the pension

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[54] The system actuary first estimated the cost of past service liability to be in excess of $120 million. After the City Attorney published this estimate, the system actuary reduced his cost estimate.

[55] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 3. See n. 46.

[56] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 3. See n. 46.

[57] The CERS actuary has estimated the cost at several million dollars.

[58] 23 July 1996 memorandum from Cathy Lexin to Larry Grissom p. 6. See n. 2.

[59] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 3. See n. 46.

[60] San Diego Charter § 99. See n. 3.

system. The pension board allowed both to occur in violation of Article XVI § 17 of the California Constitution.[61]

Under the 29 April 1996 Concept Overview, the City would pay 7.08% of payroll in fiscal year 1996 and 7.33% in 1997.[62] The City would then increase the rate by "0.50% each year until the rate paid reaches the EAN calculated rate."[63] The City was to make contributions at agreed-upon rates through fiscal year 2000; these rates would be in amounts substantially below those required under actuarial computations. This proposal to make payments at agreed upon levels and not at rates determined by an actuary violated the City Charter, which requires contributions at rates "certified by the actuary."[64]

The 29 April 1996 proposal stated that if the pension system's assets became less than 80% of the pension system's liabilities, the plan would "sunset the year following the actuarial valuation which show [sic] this funded ratio."[65] Under this plan no changes in actuarial assumptions were to occur prior to July 2000:

> There will be no changes in actuarial assumptions or actuarial methodology which would conceivably impact contribution rates prior to July 1, 2000. If the CERS Board feels its fiduciary responsibility requires a change in actuarial assumption prior to that date, this plan will sunset immediately at that time. Any additional benefits granted herein may be eliminated prospectively.[66]

Although the proposal suggested that various reserve accounts be created, the source of funds for the new accounts was to be pension fund assets. Despite discussions about them, these accounts played no significant role in the implementation of MP-1.[67] However, they did play a significant role in creating the false impression that funds were available to pay for the increased benefits. The source of funds that were to be placed into the various reserve accounts had a common origin -- trust fund assets. In other

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[61] Cal. Const. Art. XVI, § 17(a). See n. 1.

[62] These proposed contribution rates were blended -- this is, the rates paid for general member employees were averaged with those paid for public safety employees.

[63] The contribution rate paid by the City in 1996 was the PUC rate, which tended to require lesser payments into the plan in the early years and much greater amounts later. Under the EAN method the payments were level and remained stable year to year.

[64] San Diego Charter § 143; see n. 8.

[65] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 4; see n. 46.

[66] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 4; see n. 46.

[67] 16 September 2004 Report pp. 53-56. Although the reserve accounts did not play a major role in the implementation of MP-1, they did serve as a basis for issuing false and misleading statements to the investment community; see City of San Diego Website.

words, Mr. McGrory proposed using trust fund assets to pay for new benefits when the trust funds were already in the pension system and already belonged to the plan participants.

City Manager McGrory made clear that benefit increases proposed under the 29 April 1996 plan were contingent and dependent upon the pension board agreeing to accept less than the actuarially required contribution rates from the City: "The interrelationship of these various issues to each other necessitates that the entire proposal be considered and acted upon concurrently."[68]

On 29 April 1996, in his capacity as outside counsel for the City of San Diego, Jeffrey S. Leavitt, an attorney with the Cleveland, Ohio law firm of Jones, Day, Reavis & Pogue, wrote a six-page letter to Deputy City Manager Bruce Herring addressing the fiduciary implications of MP-1.[69] Mr. Leavitt concluded that the City was not acting as a fiduciary "with respect to the members of the System when revising benefits."[70] He did, however, find that the City Manager, the City Auditor and Comptroller, and the City Treasurer are fiduciaries when acting as members of the pension board.[71]

The implications of City Manager Jack McGrory acting as a fiduciary to the pension plan participants while simultaneously serving as a City fiduciary in connection with MP-1, raises a significant legal issue that was not addressed directly in Mr. Leavitt's 29 April 1996 letter. Mr. Leavitt also did not address the related legal question of Mr. McGrory's duty as a City fiduciary. Mr. Leavitt should have analyzed whether Mr. McGrory was a fiduciary to the pension plan in light of the role that Mr. McGrory was playing in reshaping the pension plan's contribution rates and reserves. Courts have uniformly held that the test for determining if an individual in Mr. McGrory's position qualifies as a fiduciary is whether the "individual exercises . . . authority or control over the plan or its assets."[72] Mr. McGrory was an agent of the pension plan's sponsor, the

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[68] 29 April 1996 City Employees' Retirement System "Concept Overview" p. 1. See n. 46.

[69] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring; the letter was purportedly provided to Mr. Herring by Mr. Leavitt "as counsel to the City with the understanding that neither Jones, Day, Reavis & Pogue nor I are assuming any professional responsibility to any other person whatsoever." See n. 26.

[70] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 2. See n. 26.

[71] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 2 (n. 5). See n. 26.

[72] See *When is Employer, Labor Union, Affiliated Entity or Person or Pension or Welfare Plan 'Fiduciary" within meaning of §3(21)(A)(i) or (III) or Employee Retirement Income Security Act of 1974* 178 A.L.R. Fed 129; see also, *Pension Ben. Guar. Corp. v. Solmsen*, 671 F. Supp. 983 (E.D.N.Y. 1987) (sponsor fiduciary under pension plan); *Schwartz v. Interfaith Medical Center*, 715 F. Supp. 1190 (E.D.N.Y. 1989) (employer acted in fiduciary capacity); *Ches v. Archer*, 827 F. Supp. 159 (W.D.N.Y 1993) (unresolved factual question about whether corporate officers acting as fiduciaries); *Hanley v. Giordano's Restaurant, Inc.*, 1995 WL 442143 (S.D.N.Y. 1995); *NYSA-ILA Medical & Clinical Services Fund v. Catucci*, 60 F. Supp. 2d 194 (S.D.N.Y. 1999).

City of San Diego. The agent of a plan sponsor can become a fiduciary by exercising any authority or control respecting management or disposition of plan assets. 29 U.S.C. § 1002(21)(A)(i); *Kendal Corp. v. Inter-County Hospitalization Plan, Inc.*, 771 F. Supp. 681 (E.D. Pa. 1991); *Landy v. Air Line Pilots Ass'n Int'l, AFL-CIO,* 901 F.2d 404 (5th Cir. 1990). Thus Mr. McGrory, as an architect of MP-1, may have, as to the particular tasks and issues contained therein, acted as a fiduciary to the pension plan participants. See *Spann v. Chicago Physicians II, P.C.*, 2000 WL 263976 (N.D. Ill. 2000) (failure of employer to perform duty related to pension plan); see also, *When is Employer, Labor Union, Affiliated Entity or Person, Or Pension or Welfare Plan 'Fiduciary' Within Meaning of §3(21)(A)(i) or (iii) of Employee Retirement Income Security Act of 1974,* 178 A.L.R. Fed. 129 (2005).

At the same time when he may have acted as a fiduciary to the pension plan, Mr. McGrory was clearly and certainly acting as fiduciary to the City of San Diego. Mr. Leavitt mentioned that the "City Council represents and is responsible to the voters and taxpayers."[73] It is universally agreed that local government officers owe their government and the people of their locality a fiduciary duty of the highest possible fidelity and of the greatest skill and diligence in their work, of which they are capable. Osborne, Reynolds, M. Jr., *Handbook of Local Government Law* (2d ed. 2001); *see Terry v. Bender*, 143 Cal. App. 2d 198 (1956); *People v. Sullivan*, 113 Cal. App. 2d 510 (1952); *see also Pharmacare v. Caremark*, 965 F. Supp. 1411 (D. Haw. 1996); *United States v. Sawyer*, 239 F.3d 31 (1st Cir. 2001) (citizens entitled to honest government services at the local level). These dual fiduciary roles and their legal implications will be discussed *infra*.

In his 29 April 1996 opinion, Mr. Leavitt does not address whether the City's representatives were acting on behalf of the City or of the pension plan. Instead, he concludes that "as settler, the City should not need to be concerned about the fiduciary implications of these proposals [MP-1]." Thus he avoided analyzing whether the City Manager and City Council were directing the City's pension board representatives to favor the City over pension plan participants. If they were doing so, a key issue would have been whether the City was acting as a fiduciary in connection with the plan to raise the system's deficit in order to allow the City to reduce the rate of its pension contributions. In his opinion Mr. Leavitt cites, but does not discuss, the case of *NLRB v. Amax*, 453 U.S. 322 (1981).[74]

In the *Amax* case the United States Supreme Court found that the fiduciary provisions of federal pension trust law (the Employee Retirement Income Security Act or ERISA) "were designed to prevent a trustee from being put into a position where he has dual loyalties, and therefore, he cannot act exclusively for the benefit of a plan's

[73] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 2. See n. 26.

[74] Mr. Leavitt cites the *NRLB v. AMAX* case for the proposition that when the employer's representatives serve on pension boards, they act on behalf of the pension board, not of the employer. However, the case also should have alerted Mr. Leavitt to the legal problems that arise when these pension board members act to advance the employer's interest at the expense of pension participants.

participants and beneficiaries." *NRLB v. Amax*, 453 U.S. at 334. According to the court in *Amax*,

> The management-appointed and union-appointed trustees do not bargain with each other to set the terms of the employer-employee contract; they can neither require employer contributions not required by the original collectively bargained contract, nor compromise the claims of the union or the employer with regard to the latter's contribution. *NRLB v. Amax*, 453 U.S. at 336. (Emphasis added.)

Despite the clear warning contained in *Amax*, the facts and circumstances show that such bargaining was going on between the board's management and labor representatives in connection with the consideration and ultimate adoption of MP-1. This reality was memorialized in writing by pension trustee John F. Casey, who complained at the time that the board, in having to deal with MP-1, was being placed in the position of a negotiator:

> With respect to the City Manager's request for benefits and changes to the retirement system, I have serious concerns that the Board action of June 21, 1996, is flawed.
>
> The proposal as submitted by the Manager, i.e., a benefit increase for a reduction in actuarial rates, placed the Board in the position of negotiator. I submit that the Board function is to administer the benefits granted by the plan sponsor and not negotiate what the benefits should be with the plan sponsor. There is no authority for the Board to engage in this activity.[75]

Pension trustees "bargain[ing] with each other to set the terms of the employer-employee contract," the very behavior condemned in *Amax*, was in play during the Spring of 1996 as board members grappled with MP-1. Moreover, it appears that pension board members who were also City employees were placed in a conflict over whether to act "for the sole benefit of the beneficiaries of the fund." *NLRB v. Amax*, 453 U.S. at 337. Again, the issue of whether the fact that the City's representatives on the pension board were negotiating benefits on behalf of the City violated their fiduciary duties to the pension system was not directly raised in Mr. Leavitt's opinion letter of 29 April 1996.

However, Mr. Leavitt did discuss features of the fiduciary issues raised by MP-1. After categorizing "the parties to the plan revision process,"[76] he found that pension board members had a trust duty to pension plan members.[77] He also found that labor

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[75] 16 July 1996 memorandum from John Casey to Fiduciary Counsel via Retirement Administrator.

[76] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 1. See n. 26.

[77] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring pp. 1-2. See n. 26.

organizations representing City employees "should not be fiduciaries under the System with respect to SDCERS members."[78] In addition Mr. Leavitt determined that California State Constitution (Article XVI §17) "subjects public pension systems to the law of trusts[79] and acknowledged that the "solely in the interest" and "exclusive purpose" language contained therein "represents the trustee's common law duty of loyalty."[80] He then admitted that pension board members have "a duty to deal fairly and in good faith with the members of SDCERS."[81]

Then at this point in his opinion, Mr. Leavitt turned California employee pension trust law on its ear. He found that "the duty of loyalty set forth in the Constitution does not automatically preclude acts which incidentally benefit persons other than members of the System."[82] However, the reduction in the City's contribution rate called for a substantial, not incidental, reduction in the City's rate of contribution. In *Board of Administration v. Wilson,* 52 Cal. App. 4th 1109, 1118 (1997), "in arrears" financing of the State pension fund by which the California Legislature attempted a six-month delay in payments to the fund was found to be "an unconstitutional impairment of contract." *Board of Administration*, 52 Cal. App. 4th at 1118.

Mr. Leavitt knew that both the reduction in the City's pension contribution rate, which was euphemistically called "rate stabilization," and changes in the plan's reserves were, from the City's point of view, "the *quid pro quo* for the proposed benefit improvements."[83] Nonetheless, Mr. Leavitt opined that the City "should not need to be concerned about the fiduciary implications of these proposals."[84] He was saying, in other words, that despite the fact that the City was paying a quid pro quo in new benefits to pension board members in exchange for a reduction in the actuarially required contribution rates, no breach of fiduciary duties by the City occurred. Even if this assessment were true and the City were not acting as a fiduciary of the pension plan, the proposal certainly raised serious issues about whether the City was inducing board members to violate their fiduciary duties by lowering the contribution rate and disconnecting the actuary from the rate setting process. See *Reich v. Hall Holding Co.*, 990 F. Supp 955 (N.D. Ohio 1998); *Williams v. Wright*, 783 F. Supp. 1392 (S.D. Ga. 1992); *Schaefer v. Arkansas Medical Soc.*, 853 F.2d 1487 (8th Cir. 1988); *Varity Corp. v. Home*, 516 U.S. 489 (1996).

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[78] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 2. See n. 26.

[79] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 3. See n. 26.

[80] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 3. See n. 26.

[81] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 4; Mr. Leavitt cited *Hittle v. Santa Barbara County Employees Retirement Association*, 29 Cal. 3d 374, 392 (1985) and *Symington v. Albany*, 5 Cal. 3d 23, 33 (1971). See n. 26.

[82] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 4. See n. 26.

[83] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 5. See n. 26.

[84] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 5. See n. 26.

Moreover, in communicating the terms of the proposed changes, the City was acting as a fiduciary. Thus when City officials, like City Manager Jack McGrory, represented that the costs of the new benefits would be paid for with "surplus earnings," they were acting as fiduciaries to the plan participants, and when Mr. McGrory stated that the City would be able to reach full actuarial funding by increasing the rate of contributions into the plan by 0.50% after reducing the rate of contributions below those actuarially required, he was acting a fiduciary to the plan participants. See *Devlin v. Empire Blue Cross and Blue Shield*, 274 F.3d 76 (2d Cir. 2001); *Degnan v. Publicker Industries, Inc.*, 42 F. Supp. 2d 113 (D. Mass. 1999); *Anderson v. Resolution Trust Corp.*, 66 F.3d 956 (8th Cir. 1995); *Dall v. Chinet Co.*, 201 F. 3d 426 (1st Cir. 1999). Again, this issue was not addressed by Mr. Leavitt, and again, Mr. Leavitt was incorrect when he said that the City need not be concerned about the fiduciary implications of these proposals.[85]

In his 29 April 1996 opinion letter, Mr. Leavitt also argued that in satisfying their fiduciary duties, board members should consider "the Proposal as a whole rather than any individual component of the Proposal that is subject to this standard."[86] Mr. Leavitt argued that the pension board should consider the funding-related changes as part of an overall program of plan revisions that would be advantageous from the perspective of the members. Again, Mr. Leavitt ignored the fact that pension board members were being asked to negotiate benefits as part of the meet and confer process and to trade off new pension benefits for a relaxation of the City's contribution rate. On its face, this plan violated the role of the pension board. *NLRB v. Amax*, 453 U.S. 322 (1981).

Mr. Leavitt did admit that the MP-1 provision that no changes in actuarial assumptions or actuarial methodology would occur if they would conceivably affect contribution rates prior to July 1, 2000, "may raise fiduciary concerns."[87] This provision violated the fundamental principle that guarantees plan participants "a contractual right to an actuarially sound retirement system." *Board of Administration,* 52 Cal. App. 4th at 1118. Mr. Leavitt's assertion that disconnecting the actuary from the process to be followed in setting the funding needs of the City's pension system was thus in error. He suggested that it would be preferable for the proposal to provide the City with "acceptable alternatives" if the board had to "change actuarial assumptions or methodology prior to July 1, 2000."[88] This advice is more akin to aiding the scheme than to offering cautionary legal advice. Mr. Leavitt failed to provide the City needed professional services with the skill, prudence, and diligence that an ordinary and reasonable lawyer would use under similar circumstances. California Civil Instruction (Standard of Care §600).

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[85] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 5. See n. 26.

[86] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 5. See n. 26.

[87] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 5. See n. 26.

[88] 29 April 1996 letter from Jeffrey S. Leavitt to Deputy City Manager Bruce A. Herring p. 5. See n. 26.

On 2 May 1996 City Manager Jack McGrory presented MP-1 to the pension board. In doing so, he represented both that "the City has been working to resolve various problems facing the Retirement System and related benefit problems"[89] and that "it has become difficult for the City to work with the System's fluctuating rates."[90] It was not so much a question of fluctuating rates as an increase in the pension's funding deficit. The unfunded liability in the pension fund had gone up from $41.3 million in 1993 to $104 million in 1995, a 153% increase.[91] Mr. McGrory was dealing with a growing unfunded liability caused by the diversion of funds from the plan and by plan mismanagement.[92]

Board member John Casey raised several red flags about the proposal:

> Mr. Casey stated that a similar proposal had been brought forward last year, and after expending a significant amount of money, the Board was advised by outside fiduciary counsel that they could not move forward with the City's proposal. He strongly stated that he did not want this to occur again. Additionally, he questioned why Mr. Wyatt's firm would not be used when they are already familiar and have been educated about our system.[93]

Board President Enerson, who had attended the 26 February 1996 meeting with Mr. Grissom and Mr. McGrory where MP-1 had been hatched, admitted that he personally directed that another lawyer be retained to replace Mr. Wyatt:

> Mr. Enerson responded that the Board had been dissatisfied with the timeliness of receiving legal opinions from that firm and their lack of responsiveness to this Board. Mr. Enerson stated that because of these reasons, he had directed Staff to contact Attorney Dwight Hamilton, who had provided the Board with a fiduciary presentation at their Strategic Planning Workshop.[94]

Mr. McGrory's 2 May 1996 Concept Overview is included in the SDCERS 2 May 1996 board meeting minutes. According to the Concept Overview:

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[89] 2 May 1996 SDCERS Retirement Board of Administration Special Meeting p. 1.

[90] 2 May 1996 SDCERS Retirement Board of Administration Special Meeting p. 1. See n. 89.

[91] 1994 SDCERS Annual Actuarial Valuation 2004; see fn 48.

[92] *See* 16 September 2004 Report p. 31 et seq. See n. 10.

[93] *See* 16 September 2004 Report p. 3; Mr. Casey was referring to Mr. Joseph Wyatt's law firm Morrison and Foerster. The firm had previously advised against a program that had some of the elements contained in MP-1. Mr. Casey raised an implied concern that Mr. Wyatt was set aside in favor of another lawyer who would under an opinion supporting MP-1. See n. 10.

[94] 2 May 1996 SDCERS Retirement Board of Administration Special Meeting p. 3. See n. 89.

> The City Manager's proposal is being reviewed by outside fiduciary counsel engaged through the City Attorney's Office and has been presented to the CERS Board's actuary for his review and advice to the Board. All proposed changes are conditioned upon and subject to final approval by fiduciary counsel, City Council approval, Retirement Board approval, vote of plan participants, and confirmation of cost estimates by the System's actuary.[95]

The MP-1 proposal described in the 2 May 1996 Concept Overview reflected the plan changes from the 28 March 1996 and the 29 April 1996 versions. First, the cost to purchasers of past service credits was set at the "full cost of such service."[96] Second, the 29 April 1996 version of MP-1 had provided that any change made by the pension board in the actuarial assumptions affecting the City's contribution rates would cause the plan to sunset immediately and any additional benefits granted under MP-1 would be eliminated prospectively.

Under the 2 May 1996 version of MP-1, an increase in actuarial rates would be "added to the PUC rate to be achieved through the phased-in rate increases."[97] Mr. McGrory also prepared a power point presentation stressing that the "Employer Rate Stabilization Plan" would have "Phased Rate Increases" and that the difference between what was paid and what needed to be paid would come from the "Stabilization Reserve."[98] However, as of 7 May 1996, City labor official Cathy Lexin had yet to receive a formal written actuarial report costing the benefits that would be created under MP-1. On 7 May 1996 Ms. Lexin asked pension plan administrator Larry Grissom if the system's actuary, Rick Roeder, was "preparing something formal in writing on the costing of the benefits we've been talking about."[99]

Representatives of the San Diego City Municipal Employees Association (MEA) also joined in the negotiations taking place among City officials and pension trustees over MP-1. On 14 May 1996, Ann Smith, MEA's attorney, asked Bruce Herring for the "dollar savings" to the City if the rate stabilization plan was implemented:

> What is the total dollar savings for the general fund during FY97 and FY 98 if the CITY's proposed retirement system funding changes—

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[95] 2 May 1996 City Employees' Retirement System Concept Overview p. 1.

[96] 2 May 1996 City Employees' Retirement System Concept Overview p. 2. See n. 95.

[97] 2 May 1996 City Employees' Retirement System Concept Overview p. 4. See n. 95.

[98] 2 May 1996 MP-1 Power Point presentation documents attached to 2 May 1996 SDCERS Board of Trustees' Minutes of Meeting.

[99] 7 May 1996 Cathy Lexin to Larry Grissom subject: "Retirement Questions."

stabilization reserve, contingency reserve, PUC to EAN funding method conversion –are adopted?[100]

On 14 May 1996, the City Council held a closed session regarding meet and confer issues. The minutes of the closed session indicate that Mr. McGrory and Mr. Herring attended. However, as with the earlier meet and confer matters, the 14 May 1996 minutes indicate the point at which the meet and confer was brought up: "This portion of the meeting ended at 10:50 a.m. Council continued the meeting to discuss Meet and Confer matters and then adjourned to open session."[101] On 15 May 1996, City Manager Jack McGrory sent a memorandum to the City Council and Mayor summarizing "the major changes you authorized yesterday for the Police Officers Association, Local 145, Municipal Employees Association, and Local 127. Ratification votes are scheduled for this week."[102]

On 15 May 1996, the City's pension board had additional discussions about the MP-1 proposal. Board member John Casey raised concerns about a new fiduciary counsel being retained to review MP-1 in place of the board's existing fiduciary counsel, Mr. Joseph Wyatt of Morrison & Foerster:

> Mr. Saathoff stated that any proposal would need approval by the Board's actuary and fiduciary counsel.
>
> Ms. Webster questioned whether the Administrator has the authority to move forward in retaining outside fiduciary counsel at this point.
>
> Mr. Saathoff responded that the Board could seek a one-time legal opinion and issue an RFI for future fiduciary services.
>
> Mr. Grissom stated that he had spoken with Dwight Hamilton regarding this issue and would be following up with him in the morning.
>
> Mr. Casey stated that the Board had previously retained Joseph Wyatt's firm as outside fiduciary counsel and has never voted to cancel that contract. He asked why new counsel was being sought for this issue when no discussion had taken place related to canceling the existing contract with Morrison and Foerster. He requested that this item be placed on the June agenda so that the Board could set a policy on how to retain/terminate counsel moving forward.

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[100] On 15 May 1996, Ms. Lexin informed Ms. Smith that the estimated difference between PUC actuarial rates and agreed-to rates in the May 2 proposal for FY97 and FY98 was $15.7million and that the general fund portion would be approximately "$10.8 million." 15 May 1996 letter from Ms. Lexin to Ms. Ann Smith.

[101] 14 May 1996 San Diego City Council Closed Session Minutes p. 2.

[102] 15 May 1996 Jack McGrory memorandum to Honorable Mayor and City Manager.

> Mr. Saathoff ensured Mr. Casey that his request would be granted and that a policy would be put place.

During the 15 May 1996 meeting, Mr. Saathoff also indicated that the pension board was anticipating a formal proposal for its consideration by June 30, 1996. Bruce Herring reported that the "Manager's office has been meeting daily to try and reach an agreement on a formal proposal."[103] Mr. Herring stated that once agreement had been reached on MP-1, the City would be asking that the "Board act expeditiously to have their actuary and fiduciary counsel review the proposal."[104]

A 17 May 1996 letter from MEA attorney Ann Smith to Cathy Lexin showed how deeply the 1996 meet and confer process over labor agreements with the City's employee unions had become entangled with the administration of the City's pension system. In her 17 May 1996 letter to Ms. Lexin, Ms. Smith wrote that the MEA wanted a "vast improvement" in the formula used to calculate pension benefits for the City's general member employees:

> I cannot state strongly enough how committed MEA's leadership and Negotiating Team are to the following outcomes: (1) a <u>vast improvement</u> in the retirement formula for general members in view of the resources available to the system [which resources constitute participants' money], and in view of the richness of the present and projected benefits for safety members by comparison; and (2) parity in general salary increases for all CITY employees regardless of job classification.[105]

Ms. Smith acknowledged that the resources available to the system that were the focus of her 17 May 1996 letter were the "participant's money" already in the pension system.[106] As such, the sole and exclusive responsibility over these assets (the participant's money) rested with the pension board of administration: "The retirement board of a public pension or retirement system shall have <u>the sole and exclusive</u> fiduciary responsibility over the assets of the public pension or retirement system."[107]

Because the MP-1 package proposed to make changes in the reserves and funding methods used by the pension system, the board of administration acting in their fiduciary duties, not City officials, should have determined how to use those funds. However, as

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[103] 15 May 1996 SDCERS Retirement Board of Administration Minutes pp. 13-14.

[104] 15 May 1996 SDCERS Retirement Board of Administration Minutes pp. 13-14. See n. 103.

[105] 17 May 1996 Letter from Ann Smith to Cathy Lexin re: MEA's Proposal for Resolution of Retirement System Issues and Contract Extension Covering FY98.

[106] 17 May 1996 Letter from Ann Smith to Cathy Lexin re: MEA's Proposal for Resolution of Retirement System Issues and Contract Extension Covering FY98. See n. 105.

[107] Cal. Const. Art. XVI, § 17(a). See n. 1.

Mr. Casey wrote, the MP-1 call for "a benefit increase for a reduction in actuarial rates" put the board in the position of a negotiator rather than administrator of the plan assets. Ms. Smith ignored that distinction in her 17 May 1996 letter.

Moreover, Ms. Smith acknowledged how difficult it would be to get plan participants to go along with the "tampering with funding methods" proposed in MP-1. Therefore, Ms. Smith proposed a quid pro quo arrangement in which the MEA would undertake the "formidable task" of persuading plan participants to go along with MP-1 in exchange for "respectable and credible" increases in benefits for MEA members:

> I also cannot over-emphasize that the level of employee skepticism and distrust regarding any tampering with funding methods related to the retirement system is enormous and will require a yeoman's effort by every person associated with MEA to overcome. MEA will not undertake this formidable task unless the gains in benefit levels for the employees MEA represents are clearly respectable and credible rather than de minimus. Frankly, at this juncture, the proposal to increase the general member's formula from 1.48% to 1.75% at age is de minimus when contrasted with a proposed safety formula of **3% at age 55** and **2.74% at age 50**.[108]

Ms. Smith closed her 17 May 1996 letter by noting that she and Cathy Lexin would be meeting on Monday, 20 May 1996.[109] On 25 May 1996, the City's pension system actuary, Rick Roeder, provided pension administrator Grissom with the "latest version" of the contribution cost estimates for MP-1. Mr. Roeder had determined that the general benefit formula and disability increases under MP-1 would require a contribution rate increase of 3.64% of general payroll. Mr. Roeder's estimates of MP-1's effect on contribution rates were as of 30 June 1995. Mr. Roeder concluded by stating that the "total increase in accrued liabilities as a result of the benefits improvements is estimated to be $76.3 million dollars."[110]

The City Council held another closed session regarding MP-1. Closed session materials that were recovered from Ms. Lexin's documents include a document entitled "Closed Session Meet and Confer 28 May 1996."[111] Among the items listed was: "1. Retirement Proposal Page No. 10-1 thru 10-4."[112] The second page of this document was entitled "Proposal Overview." One of the headings on the second page was:

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[108] 17 May 1996 Letter from Ann Smith to Cathy Lexin re: "MEA's Proposal for Resolution of Retirement System Issues and Contract Extension Covering FY98." See n. 105.

[109] 17 May 1996 Letter from Ann Smith to Cathy Lexin re: MEA's Proposal for Resolution of Retirement System Issues and Contract Extension Covering FY98" p. 3. See n. 105.

[110] 25 May 1996 Letter from Rick Roeder to Larry Grissom.

[111] 28 May 1996 Closed Session Meet and Confer documents.

[112] 28 May 1996 Closed Session Meet and Confer documents. See n. 111.

RATE STABILIZATION PROPOSAL:
Increase Employer Rates .50%/year
Provide Benefit Improvements
Pay Difference From Excess Earnings.[113]

Also contained on the second page of the 28 May 1996 closed session materials was an alternative clearly demonstrating that City officials were looking for ways to balance the City's budget:

ALTERNATIVE:
Pay the Actuarial Rate
Cut $8.66 m from FY97 Budget.[114]

Page 3 of the 28 May 1996 closed session materials described the MP-1 proposal under the heading "San Diego City Employees' Retirement System (SDCERS) P R O P O S A L."[115] Below this heading were listed the following proposed items that clearly show that the document would have fully informed the City Council of the details of the MP-1 proposal:

I. BENEFIT CHANGES
- a. Eliminate Disability Income
- b. Pre-1980 Retirees Health Insurance ($600/yr)
- c. Increase 13th Check from $30/yr of service to $60/yr for Pre-10/6/80 retirees and to $75/yr for Pre-12/31/71 retirees
- d. Provide for purchase of up to 5 years service credit
- e. Improve General Member Formula
- f. Increase Disability Benefit Formula for General Members from 33-1/3% to 50%
- g. Improve Safety Member Formula
- h. Establish a Deferred Retirement Option Plan (no cost to City/CERS)

* * *

III. RATE STABILIZATION
- a. Pay Budgeted Employer Rates for FY96 and FY97
- b. Increase Employer Rate by .50 until Rate Reaches PUC (Projected Unit Credit) Rate/Switch to EAN (Entry Age Normal) Rates When Rates Cross
- c. Pay Difference Between Actuarial Rate and Agreed-To Rate from Undistributed Surplus Earnings

[113] 28 May 1996 Closed Session Meet and Confer documents p. 2. See n. 111.

[114] 28 May 1996 Closed Session Meet and Confer documents p. 2. See n. 111.

[115] 28 May 1996 Closed Session Meet and Confer documents p. 3. See n. 111.

IV. RESERVES

a. Create Contingency Reserve (1% of assets)
b. Create Stabilization Reserve (up to $75m from Surplus Undistributed Earnings

V. APPROVAL PROCESS

a. Contingent Upon All Labor Organizations Ratifying FY98 MOU Extensions and Supporting Changes with CERS and Participant Vote
b. Contingent Upon Approval of CERS Board, Fiduciary Counsels, City Attorney & Actuary
c. Contingent Upon Final Approval of City Council.[116]

The 28 May 1996 minutes of the City Council's closed session indicate that Mr. McGrory and Mr. Herring were present. The minutes show that after considering unrelated litigation matters "Council continued with meet and confer items until 10:00 A.M."[117]

On 29 May 1996 Ms. Cathy Lexin, the City's labor relations manager, provided the City's outside fiduciary counsel with "what we believe to be the final draft of the City Manager's Proposed Changes to the San Diego City Employee's Retirement System." Ms. Lexin noted that the major difference in the new draft dated 28 May 1996 is "the inclusion of a benefit/formula improvement for the Safety Members."[118]

On 4 June 1996, the San Diego City Council held a closed session to discuss meet and confer items. In attendance were City Manager Jack McGrory and Deputy City Manager Bruce Herring.[119] Materials for the 4 June 1996 closed session contained meet and confer documents, including the "Retirement Proposal" and a "City Employees Retirement System June 4, 1996 Proposal."[120]

By June 5, 1996, Ron Saathoff, president of San Diego City Fire Fighters Local 145, Garry Collins, president of the San Diego Police Officers Association (POA), Ed Lehman, president of AFSCME Local 127, and Judy Italiano, president of MEA, had signed off on the 4 June 1996 proposal. [121] In each instance the signatures of the union

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[116] 28 May 1996 Closed Session Meet and Confer documents p. 3. See n. 111.

[117] 28 May 1996 San Diego City Council Closed Session Minutes p. 2.

[118] 29 May 1996 Letter from Cathy Lexin to Jeffrey Leavitt (with 28 May 1996 proposal attached) with a copy to Deputy City Attorney John Kaheny.

[119] 4 June 1996 San Diego City Council Closed Session Minutes.

[120] 4 June 1996 Closed Session Agenda "City Employees Retirement System June 4, 1996 Proposal."

[121] 4 June 1996 Management Proposal with Fire Fighters Local 145 (signed 5 June 1996), the POA, AFSCME Local 127, and the MEA for the FY98 MOU Extensions.

representatives were preceded by a provision, acknowledged and agreed to by the union presidents on behalf of their respective unions, that the "interrelationship of these various issues to each other necessitates that the entire proposal be considered and acted upon concurrently."[122]

On 6 June 1996, City Manager Jack McGrory informed the Mayor and City Council that an agreement had been reached on 5 June 1996, with MEA and Locals 127 and 145 on the "proposed changes to the City Employees Retirement System" contained in the 4 June 1996 proposal.[123]

The 4 June 1996 proposal agreed to by the City and its four union presidents, which was based upon an estimated cost of $110.35 million, provided not only that the cost would be "paid from excess earnings [and] includes $71.31 million in contributions as a result of benefit improvements"[124] but also that employees would pay the "full cost" of the pension service credit benefits. The proposal also increased the percent of salary that general members earn each year from 1.48% to 2.0% at age 55. This was certainly the "respectable and credible rather than de minimus" increase that Ms. Smith had sought in exchange for the MEA's support of the MP-1 proposal.

The past liability for increases in general member pension and disability payments was to "be paid for by the City through excess earnings." The employer's share was to be "added to the actuarial rate (PUC) calculations beginning mid-year FY97. The employee's share was in part to be "paid from excess earnings for FY97."[125] Again, this was an agreement simply to increase the pension deficit and push the costs of the benefits onto future generations. Regarding the DROP program, the 4 June 1996 proposal provided that it "would have no cost impact to the City or CERS" and that the City would, at the end of three years, have the right to evaluate the effect of the program and the unilateral right to prospectively terminate it.[126]

The 4 June 1996 proposal was revised on 6 June 1996, and then again on 7 June 1996. Under the terms of the latter version, the City was offering seven benefit increases

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[122] 4 June 1996 Closed Session Agenda "City Employees Retirement System June 4, 1996 Proposal." See n. 120.

[123] 6 June 1996 Memorandum from City Manager Jack McGrory to Mayor and City Council re: Labor Negotiations FY 98 Tentative Agreements.

[124] 4 June 1996 Closed Session Agenda "City Employees Retirement System June 4, 1996 Proposal," p. 5. See n. 120.

[125] 4 June 1996 Closed Session Agenda "City Employees Retirement System June 4, 1996 Proposal" p. 3. See n. 120.

[126] 4 June 1996 Closed Session Agenda "City Employees Retirement System June 4, 1996 Proposal" p. 5. See n. 120.

in exchange for a reduction of the City's contribution rate to the pension fund,[127] and the City's power to rid itself of the DROP program was weakened:

> At the end of three (3) years, the City will evaluate the cost impact of this program. If the cost impact to the City or CERS is greater than the savings, the City agrees to meet and confer to impasse prior to imposing any changes in the DROP plan. If the City proposes to change the DROP Plan, the 90% cap on CERS would also be re-negotiated.[128]

On 11 June 1996, the City's pension board convened a "special workshop" to discuss the 7 June 1996 version of City Manager Jack McGrory's MP-1 proposal. The purpose of this meeting, which was held with the understanding that "no action" would be taken on the MP-1 proposal "until the regularly scheduled Board meeting of 21 June 1996,"[129] was to receive "1) presentation of the Manager's proposal by Mr. McGrory; 2) questions and comments from the Board; fiduciary counsel Dwight Hamilton; and actuary Rick Roeder."

During his 11 June 1996, presentation at the workshop, Mr. McGrory reminded the pension board that on 2 May 1996, he had provided a draft of MP-1.[130] Mr. McGrory indicated that representatives from his office had discussed MP-1 with the board's actuary and the City's independent fiduciary counsel.[131] He then summarized the proposal:

> Mr. McGrory summarized the proposal stating that it offers improved retiree cost-of-living benefits and health insurance which if adopted, would become a System liability; it recommends elimination of the disability offset; offers a wider purchase of service program at no additional cost to the City; includes a DROP plan which is similar to a deferred retirement; and would assist the City in stabilizing their contribution rates. This would be accomplished through changing the System's funding methodology by eliminating the current PUC (Projected Unit Credit) method, and phasing in the original EAN (Entry Age Normal) method over a period of time.[132]

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[127] 4 June 1996 Closed Session Agenda "City Employees Retirement System June 4, 1996 Proposal" pp. 2-6. See n. 120.

[128] 7 June 1996 City Employees Retirement System Proposal p. 5.

[129] 11 June 1996 Minutes of the SDCERS Special Workshop meeting p. 1.

[130] 11 June 1996 Minutes of the SDCERS Special Workshop meeting p. 1. See n. 129.

[131] 11 June 1996 Minutes of the SDCERS Special Workshop meeting p. 2. See n. 129.

[132] 11 June 1996 Minutes of the SDCERS Special Workshop meeting p. 2. See n. 129.

After discussing the benefits to be given in exchange for reduced City contributions to the plan, Mr. McGrory represented that the City would increase its contributions to the pension plan:

> As the proposal related to the City's contribution rates, Mr. McGrory stated that it is recommended that the employer contribution rate be increased beginning in fiscal year 1998, but that the increase be phased in over time at a rate of 0.5% per year, until such time as the rates equal Entry Age Normal (EAN) as determined by the Board's actuary. At that time, it is recommended that the City convert from the PUC (Projected Unit Credit) funding to EAN. Until then, the difference between the PUC rate, as determined by the actuary, the rate of the 0.5% per year would be paid from the System's earnings stabilization rate reserve. He stated that the City had budgeted 7.08% for the current fiscal year and that the PUC rate is 8.06%-this would increase to 10.87% and up to 12.18% in the year 2007. *** This reserve would be used for two purposes: 1) to pay for all of the costs for employees who would receive the retirement formula benefit increase (approximately $71.31 million); and, 2) to assist the City in stabilizing and increasing their contribution rates using the additional $39 million.
>
> He stated that currently there is approximately $10.07 million in the earnings stabilization reserve which was created last year and an additional $18.85 million which is 50% of the 1995 surplus, for a total of $29.55 million. He stated that the City is proposing to transfer the $29.55 million into the stabilization reserve, and that the actuary has estimated $116 million in total earnings to the System in FY 96. Once the distribution to the employer/employee reserve, the retirement administration costs, the health insurance and 13th check benefit have occurred, there would be approximately $70.7 million remaining, with $79.3 million in surplus undistributed earnings. The City is proposing that 50% of that be transferred to the earnings stabilization reserve for an additional $39.65 million. This would result in the creation of a System earnings stabilization reserve of $69.2 million this year.[133]

According to the San Diego City Attorney, in representing the MP-1 proposal to the board, Mr. McGrory was acting as a fiduciary to the board. As such, he failed in his duty to advise the board that the moneys in the pension system that he proposed to use for the stabilization reserve already belonged to the system.

At the 11 June 1996 workshop, Mr. McGrory told the pension board members that the meet and confer process had been completed.[134] In addition, Mr. McGrory stated

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[133] 11 June 1996 Minutes of the SDCERS Special Workshop meeting p. 4. See n. 129.

[134] 11 June 1996 Minutes of the SDCERS Special Workshop meeting p. 4. See n. 129.

that "the Board's actuary had provided the City with all of the cost information related to these proposals."[135] The discussion then turned to how the "surplus earnings" could be used to finance the costs of the increased benefits, and the pension administrator attempted to explain how the process works:

> In response to Ms. Wilkinson's question, Mr. Grissom stated that the stabilization reserve is money held outside of the assets used for the purpose of the actuarial valuation. When this occurs, money is transferred from that fund back into System assets. While the fund is not "whole" per se, a step has been made toward keeping the liability from growing to a much higher level.
>
> Ms. Wilkinson then asked if the numbers were arbitrary as far as the difference is concerned.
>
> Mr. Grissom responded that once all has been paid as required by the Municipal Code, the remainder is considered to be surplus earnings. As it now stands, 100% of surplus earnings is put back into the employer contribution reserve for the sole purpose of reducing the System's unfunded liability. What this plan visualizes is that 50% of that surplus would be put in the stabilization reserve, while the other 50% would be put into the employer's contribution reserve. As a means to make this rebalancing possible, money would be taken from the stabilization reserve and put back into the employer contribution reserve.

Article XVI § 17 of the California Constitution is clear that public pension plan assets are to be administered by the pension board -- that is, not by City Manager Jack McGrory: "the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system"[136] and the "sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system."[137] Moreover, the assets of the pension fund belong to the pension fund and should not have been used to finance the City's contribution rate reductions: "The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system."[138]

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[135] 11 June 1996 Minutes of the SDCERS Special Workshop meeting p. 4. See n. 129.

[136] Cal. Const. Art. XVI, § 17(a). "The power of the board of administration of a pension plan is subject to conditions discussed herein." See n. 1.

[137] Cal. Const. Art. XVI, § 17(a). See n. 1.

[138] Cal. Const. Art. XVI, § 17(a)(b). See n. 1.

In addition, the retirement board and plan administrator were wrong when they allowed the City's budget priorities to take precedence over their duties to plan participants by their agreement to permit the City to pay less than the actuarially required funds needed by the plan:

> The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty.[139]

During the 11 June 1996 workshop, Mr. McGrory told the board that he had "spent a significant amount of time working with members of Staff and the Retirement Board on the MP-1 proposal. Board president Enerson concurred"[140] and admitted that on numerous occasions he had met with the manager's office to develop a proposal that would be acceptable to all parties involved.[141] The pension plan administrator, Lawrence Grissom, was a fiduciary to the plan and should not have been involved in using plan assets ("surplus earnings") to reduce the City's legal liability to make actuarially determined contributions to the plan.[142]

Mr. Roeder verified that his firm had generated the numbers that were presented:

> Mr. Roeder confirmed that the numbers that were presented were generated by his firm. He stated that if all of these benefits are put into place and are reflected in the 6/30/96 valuation, from a technical standpoint, there would be approximately $80 million which will have the impact of a 5% reduction in whatever the funding ratio would be at that point.
>
> ***
>
> Mr. Casey asked about the long-term impact of creating the contingency and stabilization reserves and how this would affect the System 10-15 years in the future.

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[139] Cal. Const. Art. XVI, § 17(b). (Emphasis added.) See n. 141.

[140] 11 June 1996 Minutes of the SDCERS Special Workshop meeting p. 12. See n. 129.

[141] 11 June 1996 Minutes SDCERS board of trustees Special Workshop p. 12. See n. 129.

[142] San Diego Charter § 143. ("City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by the actuary."). See Cal. Const. Art. XVI, § 17(a); see also Employee Retirement Income Security Act (ERISA) § 404(a)(1), requiring fiduciaries to act solely in the interest of plan participants and beneficiaries. See n. 8.

> Mr. Roeder responded that the impact would be relatively negligible to the extent that the amounts that are set aside would be periodically reviewed and used to fund part of the City's contributions in bad market years.
>
> ***
> In relation to the 10% drop, Mr. Roeder stated that if the funded ratio drops 10% from the June 30, 1996 funded ratio, the proposal sunsets. Additionally, he said that there may be actuarial gains this year. Absent any benefit increases, he reported that the System may have been at a 90%-95% funding level.
>
> Ms. Wilkinson stated that a 15% drop would lower the System's funding level to the high 70 percent range and asked what this amounts to in dollars.
>
> Mr. Roeder responded that the 10% drop would not occur for another 5-6 years and that this would be hard to predict. However, he stated that currently, the amount at 15% would be approximately $225 million.
>
> Mr. Roeder responded that he would have been reluctant to recommend this plan without some sunset provisions. However, he stated that he believes that this is a sound proposal as long as the funded ratio does not drop significantly, and with the appropriate sunset[143] provisions in place.[144]

It was at this point that Mr. Roeder's firm and clear advice could have made a critical difference in stopping the ill-fated MP-1 proposal from going forward. However, Mr. Roeder at this meeting and throughout MP-1 negotiations instead adopted the role of facilitator rather than independent adviser working for the best interests of plan participants. With his advice to the pension board in considering MP-1, Mr. Roeder's conduct fell below applicable professional standards,[145] for in providing guidance to the pension board on explaining the actuarial affect of MP-1 to plan participants and board members, he was acting as a plan fiduciary.

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[143] In 2002 when the trigger was hit, the sunset provisions should have kicked in, and the benefits created under MP-1 should have been set aside. This result did not occur. During the 11 June 1996 workshop, Mr. Grissom stated that the sunset provision "is applicable to the entire proposal." 11 June 1996 Minutes of the SDCERS Retirement Board Special Work Shop meeting. See n. 129.

[144] 11 June 1996 Minutes SDCERS board of trustees Special Workshop p. 12-15. See n. 129.

[145] See generally June 2005 letter from the City of San Diego Audit Committee relating to Mr. Roeder; *When Is Employer, Labor Union, Affiliated Entity or Person or Pension or Welfare Plan 'Fiduciary' within meaning of §3(21)(A)(i) or (iii) or Employee Retirement Income Security Act of 1974* 178 A.L.R. Fed. 129 (2005). See n. 72.

The central reality of the MP-1 proposal was the agreement among all the parties to pass on the costs of the new benefits and intentional underfunding of the pension plan to future generations. The pension board's 11 June 1996 discussion focused on this reality:

> She [Ms. Jamison] questioned whether future tax payers would be placed in a position of having to pay for these benefit increases if they are adopted, and how this curve would affect the City's obligation.[146]
>
> ***
>
> Mr. Casey stated that there is an underlying statement in the Charter that indicates that today's service credit must be paid for by today's taxpayers. He stated that this proposal gives him the distinct impression that future taxpayers will be paying for these benefit increases. He questioned if this would be the case.
>
> ***
>
> Mr. Casey stated that if this proposal is implemented, he has concerns that the younger generation will be expected to pay retirement benefits for today's generation. He stated that he does not believe this is appropriate.
>
> Mr. Roeder responded that there is no question that the rate that is being agreed upon is less than what he considers to be the 'ivory tower' actuarial rate over the next ten years. Therefore, some of these costs <u>will be borne by the future generation</u>. (Pension Board's 11 June 1996 Meeting)

In assessing the effect of MP-1 on the pension system, neither the pension board members, the pension administrator, nor the actuary asked the right questions or took the right actions, and because of their failure, the San Diego City pension plan faces a historic financial crisis. The pension plan has a deficit of at least $1.7 billion dollars. Plan participants hold paper interests that are worth about 60 cents on the dollar. Pension plan fiduciaries violated their constitutional duty to prudently manage the City's pension plan:

> (c) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the <u>care, skill, prudence</u>, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.[147]

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[146] 11 June 1996 Minutes SDCERS board of trustees Special Workshop p. 15. See n. 129.

[147] *See* Cal. Const. Art. XVI, § 17(c). (Emphasis added.) See n. 1.

The pension board also heard from a privately retained legal counsel regarding the fiduciary implications of the MP-1 proposal. Mr. Wyatt from Morrison & Foerster, whom the board had previously retained to advise it on fiduciary matters, had cautioned against using pension money to fund a reserve account without an actuarial determination that the moneys so used were not needed by the fund to meet its actuarially determined funding needs.[148]

Mr. Hamilton told the board that "there were 'red flags' raised in his mind by this proposal as it relates to the Board's duty of loyalty to the integrity of the fund and addressed those individually."[149] Mr. Hamilton also indicated that he was troubled by the ambiguity of MP-1's sunset provision:

> Additionally, he said that he was troubled by Issue #3. More specifically, he was troubled by the fact that the sunset provision does not spell out what would occur if the funded ratio were to fall lower than 10% and the sunset were to go into effect. He stated that this could have a drastic change or effect on the fund itself and the investment benefits. He stated that as it relates to the Board's loyalty to the beneficiaries, he believes that it is important that the proposal spell out exactly what will occur if [it is] sun setting.[150]

Mr. Hamilton raised additional concerns that MP-1 provisions would violate the right of the pension participants to a sound actuarial system:[151]

> Another troublesome area to Mr. Hamilton was the specific agreement that there would be <u>no changes in actuarial assumptions</u> or methodology until fiscal year 2007. He reminded the Board that the pension beneficiaries and members have a vested right to an actuarially sound system and that the Board has a duty of loyalty to the integrity of the fund that cannot be contracted away. He stated that he believes that the Board's right to <u>annually and continually review</u> their methodology and assumptions is essential. He was concerned that the agreement says that this will not change until the year 2007. Additionally, the statement that reads "…under extraordinary circumstances, the Board might be able to change those actuarial assumptions …" troubled him because the definition of "extraordinary circumstances" is unclear. He stated that this language needs to be specific.

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[148] *See* 22 August 1995 letter from Morrison & Foerster to SDCERS administrator Lawrence Grissom.

[149] 11 June 1996 Minutes SDCERS Board of Trustees Special Workshop p. 18. See n. 129.

[150] 11 June 1996 Minutes SDCERS Board of Trustees Special Workshop pp. 19-20. See n. 129.

[151] See *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109 (1997); see Addendum of Cases.

As MP-1 was revised, the underlying funding flaw became apparent. For fiscal year 1996, the City was to reduce its contribution rate from its current level of 8.6% to 7.08%. While it was reducing its contribution rate, the City would significantly increase the contribution rate needed to pay for the new benefits. After fiscal year 1997, the City would begin fixed payments, which would increase by .05% through 2006.

The pension board should have computed whether a .05% increase in the City's contribution rate starting in 1998 would be greater than the contribution rate needed to pay for the new benefits and for the growth of plan liabilities. Moreover, for the pension board to meet its duty to provide an actuarially sound system to the plan beneficiaries and for the City to ensure that its funding needs were met, an actuarial analysis should have been completed. Mr. Hamilton did not focus on the needed computation of any gap between the increased costs for the new benefits and the .05% increase in the City's contribution rate starting in 1998. However, as set forth above, he did focus on the failure of the MP-1 plan to provide for regular annual actuarial analyses of the funding needs of the City's pension plan.

Under the funding plan any difference between the system's actuarially determined funding needs and the amounts that the City paid into the system were to be paid out of a stabilization reserve. Although plan administrator Grissom stated that the stabilization reserve "would be capped at $75 million,"[152] the stabilization fund was to be funded with "surplus earnings," which were already plan assets.

The use of "surplus earnings" to fund the stabilization fund would dollar-for-dollar increase the unfunded liability -- that is, for each dollar transferred out of the system into the stabilization fund, the City would have to pay another dollar back. Thus the funding plan to pay for the new benefits was merely smoke and mirrors. This assessment was confirmed by the fact that the complicated reserves were not used to pay for any of the additional benefits. Rather, these costs were simply added to the unfunded liability of the pension plan. Moreover, actuary Roeder's cost estimates for the new benefits proved to be understated.[153]

During the 11 June 1996 workshop, Mr. Hamilton was grilled about the fact that MP-1 would be transferring the costs of the new benefits to the next generation:

> Ms. Parode raised concerns about Mr. Hamilton's statement that the decision to enrich benefits at the expense of the funding future of the fund would be one of a business issue and not a fiduciary issue seemed inappropriate. ***

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[152] 11 June 1996 Minutes SDCERS Special Workshop p. 10. See n. 129.

[153] Although the gap between the actual costs of the new benefits created by MP-1 and those estimated by actuary Roeder will have to be determined by a new independent actuary, the amount will be multiple millions of dollars.

> Mr. Hamilton responded that if this is what he said, it was not what he meant. He clarified that the Board has a duty to protect the integrity of the fund. Therefore, benefits could be increased whereby the integrity of fund is not destroyed. On that the Board must rely on their actuary to ensure that the decision is actuarially sound. Additionally, he stated that just because the Board would be increasing the unfunded ratio does not necessarily mean that this would be a breach of fiduciary duty.
>
> Ms. Parode asked if there are any standards available to fiduciaries regarding funding levels, stating that she assumes not all systems are fully funded. However, she questioned how far unfunded a system can become before becoming susceptible to a challenge on the Board's management of the fund.
>
> Mr. Hamilton responded that it is not so much that the System is becoming unfunded, but that the liability of current employees/retirees are being transferred to future taxpayers.[154]

Missing from this discussion was the fact that the City was not operating within its Charter § 99 expenditure control provisions and that City Manager Jack McGrory and the City Council owed a fiduciary duty to the City of San Diego and its taxpayers just as the pension board owed a duty to plan participants.

Ms. Parode did not let Mr. Hamilton off the hook; instead she pressed him to explain the nature of the pension board's duty to assess the City's financial ability to pay for the new benefits:

> Ms. Parode asked whether the Board has a fiduciary duty to look at the future financial situation of the City prior to approving this.
>
> Mr. Hamilton responded that the City is the settlor of the trust and that it is their employees' basic responsibility to fund it. He stated that in what he had heard today, he believes that there had been some unrest between the City and the Board based upon this exact issue. He stated that although the fund has earnings, the City does not understand why those monies cannot be used to alleviate their basic responsibility. He stated that these are difficult issues and that the Board must work with their actuary and fiduciary counsel to determine this. Decreasing the amount the employer would be paying to fund the trust on the basis that this will eventually come together from an actuarial standpoint does not necessarily mean that this would be a breach of fiduciary duty.

[154] 11 June 1996 Minutes SDCERS board of trustees Special Workshop pp. 22-23. See fn. 129.

Mr. Hamilton responded to direct questions about the previous opinion issued by Mr. Joseph Wyatt of the Morrison & Foerster firm regarding the use of plan assets to fund the stabilization reserve:

> Mr. Hamilton responded that he had reviewed Mr. Wyatt's opinion. He stated that the key to the stabilization reserve is under the Claypool case, which says that the funds must be actuarially available. Because the Board has no way of knowing whether those funds would be actuarially available, he stated that he agreed with Mr. Wyatt's opinion regarding the annual funding of the stabilization reserve from the surplus.[155]

Thus Mr. Hamilton had concluded that the funds that Mr. McGrory had indicated would be available to pay for the increased costs and reduced contributions from the City were not yet determined to be "actuarially available" -- a precondition to the intended use. Ms. Parode had uncovered the major defect in the MP-1 plan. No legal source of funds was identified to pay for either the reduced contributions or the increased benefits.

There was a flurry of activity during the 10 days following the 11 June 1996 MP-1 workshop and before the pension board was to meet on 21 June 1996, to consider the approval of MP-1. On 19 June 1996, the pension board administrator described additional revisions to MP-1 following the 11 June 1996 workshop. With regard to the reduction of the City's contribution rate, a new trigger feature was added to MP-1, requiring that, if the pension plan's funded ratio fell below 10% of its 30 June 1996 ratio of 92.3%, or in other words, if it fell below the 82.3%, the City would increase its contribution as the actuary determined was necessary.

> B. The city will pay the agreed to rates shown above for FY 96 through FY 2007. In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996, actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City paid rate will be the amount determined by the actuary necessary to restore the funded ratio to the proper level.
>
> C. If the System's actuary makes changes in actuarial assumptions or methodology which are approved by the Board prior to July 1, 2007, any changes in the employers contribution rate will adjust the PUC rate to be achieved through extended incremental increases shown in paragraph A. above. If the phase in would require an extension past July 1, 2009, in order to achieve the full actuarial PUC rate, the City paid rate will be adjusted by the amount necessary to achieve full phase in by that date.[156]

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[155] 11 June 1996 Minutes SDCERS board of trustees Special Workshop p. 23. See n. 129.

[156] 19 June 1996 memorandum form Larry Grissom to Cathy Lexin re: San Diego City Employees' Retirement System Issue No. 3 Employer Contribution Rates.

Although these revisions created several problems, one central fact emerged: The revised MP-1 removed any possible doubt that the benefit costs were going to be passed on to the next generation of San Diegans. Any increase in the pension deficit due to the benefit increases or contribution rate reductions was going to be added to the pension short-fall, and the amortization period was to be extended indefinitely into the future. The hard questions asked by Ms. Parode and Mr. Casey forced revisions to MP-1 that led City, pension, and union officials pushing MP-1 to engage in ever more blatant fraudulent and unlawful behavior.

On 21 June 1996 SDCERS outside counsel Dwight Alan Hamilton provided Cathy Lexin with a draft of his opinion letter supporting MP-1.

An undated memorandum written before but in reference to the 21 June 1996 retirement board meeting and secured from the files of City labor negotiator Mike McGhee established that the following were "matters of fact for the record that are part of the deal":[157]

> If the retirement deal is approved by the Retirement Board, at the June meeting, we believe the following are matters of facts for the record are part of deal:
>
> 1. Fiduciary Council [sic] will have unequivocally approved the deal as being legal.
>
> 2. The Actuary needs to be on record as to the total cost of the deal (Rick Roder's June 13th memo is not the total cost. It doesn't include the cost of pulling funds out of the system to bridge the short falls and the un-assumed (by the Retirement Board) benefit increases. The Actuary needs to be on the record point by point in the deal. The point by point costing by the Actuary should include the drop plan will not cost the City money, and the buy back will not cost the City money.)
>
> 3. After we have that cost signed on by the Actuary, we must also get from the Actuary the funding level drop in the system. For the record, only after the funding level has dropped from all facets of this proposal, will the 10% drop in funding level that counts toward sunseting the deal start. Not before.
>
> 4. By doing this deal the Retirement Board is agreeing to keep the rates at the attached schedule.
>
> 5. In agreeing to this deal the Retirement Board is implicitly agreeing to not arbitrarily change Actuarial's [sic] assumptions to the

[157] Undated check list compiled on or after 13 June 1996, and before 21 June 1996, relating to MP-1; secured from the files of City labor negotiator Mike McGee. See n. 157.

detriment of the City. This doesn't mean they can't change Actuarial assumptions, it just means they won't do so arbitrarily to the determent of the City. It also means that if they do, the rate changes will be phased in at the end of the agreed to schedule.

6. It would be a point of good faith on the Retirement Board's part to agree not to count any of their unilateral assumption changes toward the 10% sunset provision.

7. Fifty percent (50%) of excess earnings will go to a stabilization reserve as long as necessary to cover the costs of implementing this agreement. [A wavy line appears on the document through No. 7.]

8. **

9. **

10. The cost of the five-year buy back plan (purchase of service credit), is to be implemented at no cost to the City. ***

11. General members are eligible for the drop plan.

12. The drop plan negotiations will not cause this plan to sunset.

13. If the Retirement Board approves this deal and it is subsequently overturned after implementation, by the terms of the deal by City can reduce the benefits back to the position it was before the deal.[158]

On 21 June 1996 SDCERS outside counsel Dwight Alan Hamilton provided Cathy Lexin with a draft of his opinion letter supporting MP-1. The final version of Mr. Hamilton's opinion, also dated 21 June 1996, was forwarded to pension administrator Lawrence Grissom. In his letter Mr. Hamilton stated in reference to the proposed rate stabilization plan that "[n]othing in this proposal changes the Board's discretion to adjust the actuarial assumptions on which the System is based as needed in order to insure the long-term funding integrity of the System."

This statement is false. The proposal limited the pension board's ability to impose an immediate increase in the City's contribution rate to meet the pension system's actuarial funding needs as is mandated by San Diego Charter § 143 and California Constitution Article XVI, § 17(a)-(c). Mr. Hamilton was aware that MP-1 restricted the

[158] Undated check list dated on or after 13 June 1996, and before 21 June 1996, relating to MP-1; secured from the files of City Labor negotiator Mike McGee.

board's discretion to manage the pension system in a way reflective of the actuarial needs of the pension system, not of the budget priorities of the City.

In his 21 June 1996 letter to pension board administrator Grissom, Mr. Hamilton admitted that he was aware of these limitations on the pension board to set actuarial rates under MP-1:

> If the phase in would require an extension past July 1, 2009, in order to achieve the full actuarial PUC rate, the City-paid rate will be adjusted by the amount necessary to reach by July 1, 2009, the rate calculated by use of the entry age normal method.[159]

Mr. Hamilton did not address the City's practical ability to make the rate adjustments by 1 July 2009, in order to fulfill the promise to adjust the contribution rate needed to reach EAN by 2009. Moreover, this agreement substantially extended the period during which the pension system would be underfunded. This extension violated the contractual rights of the pensioners to an actuarially sound pension system. *Board of Administration v. Wilson*, 52 Cal. App. 4th 1109 (1997) (arrears financing of pension contribution for only six months violated contractual right to actuarially sound pension system). By limiting the power of the board to impose contribution increases, the delayed implementation of full actuarial rates served the interests of the City at the expense of plan participants.

Mr. Hamilton also opined that it was "appropriate and the Board will be discharging its fiduciary responsibility to credit the employer contribution reserve" in the amount of $106,700,000.[160] This allocation to the reserve was to come from both "surplus" undistributed earnings and a balance in the earnings stabilization reserve.[161] However, Mr. Hamilton did not discuss the fact that these funds added directly to the underfunding of the pension plan. The scheme chosen was a convoluted way of admitting that the City did not have enough money and was therefore borrowing it from the pension plan. Eventually, the borrowing was dropped, and the costs of the increased benefits were simply added to the pension deficit. Again, Mr. Hamilton's statements in this regard were false and misleading to taxpayers, the San Diego media, and investors in San Diego City bonds.

On 21 June 1996 Assistant City Auditor Terri Webster sent an email to "city-mgr.CTL" (Cathy Lexin) regarding the 21 June 1996 revised version of MP-1. In her e-mail, Ms. Webster noted there was to be a 1:00 pm meeting with City Manager Jack McGrory, preceded by a meeting in which Ms. Webster briefed City Auditor Ed Ryan.

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[159] 21 June 1996 letter from Dwight A. Hamilton to Lawrence B. Grissom.

[160] 21 June 1996 letter from Dwight A. Hamilton to Lawrence B. Grissom p. 3. See n. 159.

[161] 21 June 1996 letter from Dwight A. Hamilton to Lawrence B. Grissom p. 3. See n. 159.

Ms. Webster told Ms. Lexin about the "4 main points that need to be added to the [MP-1] proposal."

> 1) The proposal needs to state that ALL costs associated with the proposal need to be worked into the 6-30-96 valuation that will be used as the base from which the 10% decrease will be measured. (this includes costs associated with 13th check, health, etc. We know that Rick doesn't normally calculate it that way but it needs to be done somehow to give as much breathing room from the 10% deal breaker.
>
> 2) City needs protection from scenario where third party actions result in killing the deal AFTER benefits have been given and cannot be taken back.
>
> ie. No Charter amendment and therefore City has to keep health; or no DROP plan; or determination that City can not pay the lower rates. <u>The City cannot afford to pay the higher benefits without the offset of rate relief</u> and elimination of health expense.
>
> 3) The proposed needs to specify that an experience valuation will not occur until 6-30-99. This is needed to reduce the risk that the deal will die within the first five years do to funding ration (sic) dropping more than 10% below the 6-30-96 valuation.
>
> 4) Since the proposal was changed to eliminate the contingency and stabilization reserve the City needs to be told of the replacement to ensure that there is a minimum of 2 years coverage for health and 13th check ($18M).[162]

Ms. Webster's memorandum makes it clear that the MP-1 proposal was directed at allowing the City to pay less than the actuarially required rate for as long as possible. This memorandum contradicts the letter in which Mr. Hamilton found no fiduciary breach, for in the letter he described the relief provided to the City in more obscure terms that simply did not comport with the realities of contribution rate relief Ms. Webster admitted to in her 21 June 2001 memo to Ms. Lexin.[163]

Although some board members complained about being rushed into making a decision, on 21 June 1996 the San Diego pension board approved MP-1 by a vote of 8 to 3. The pension trustees voting in favor of MP-1 were Terri Webster, Bruce Herring, Sharon Wilkinson, Robert Scannell, Keith Enerson, Ron Saathoff, John Torres, and Conny Jamison. The three voting in opposition were Jack Katz, Ann Parode, and Paul

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[162] 21 June 1996 memorandum from Terri Webster to city_mgr.CTL.

[163] 21 June 1996 memorandum from Terri Webster to city_mgr.CT. See n. 162.

Barnett.[164] Mr. Barnett noted that that the board was being asked to allow the "[s]ystem to remain under-funded by a considerable amount and using the system's surplus to help pay for additional benefits and assisting the employer with their contribution rates."[165]

Ms. Parode, who believed that board members should judge the City's ability to make the payments that would be due by fiscal year 2008, asked attorney Hamilton if, during 2000, the board would be required to evaluate the City's ability to make its financial commitments. Mr. Hamilton disingenuously responded that "if the City had not been involved with this particular proposal, the Board might be asking the same question."[166]

Three months later Mr. Hamilton had to revise the opinion that he had given in response to Ms. Parode's assertion that the pension board needed to evaluate whether the City would be able to meet its obligations under MP-1. Contradicting the statement that he had made at the 21 June 1996 board meeting, Mr. Hamilton, in a 19 September 1996 letter, agreed with Ms. Parode:

> Ms. Parode, in her comments at the 21 June 1996, public hearing on the City's Manager's proposal, compared the approval of employer contribution payments at a level less than that recommended by the actuary to that of a retirement system loaning money to an employer. Before a bank makes a loan, it has the duty to determine the ability of the borrower to repay it. We believe that the Board is held to the standard of professional bankers and bank investment advisors. If a pension fund is asked to approve employer contribution payments at a level less than the amounts recommended by the actuary, because of the unfunded liability created, the fiduciary must determine the ability of the employer to provide the funds to deliver benefits and related services to the participants and their beneficiaries when they become payable.
>
> To discharge the duty of determining the ability of the City to provide the funds to deliver benefits and related services to participants and their beneficiaries, the Board should give appropriate consideration to audited financial statements of the City; determine whether the City is reasonably carrying out and performing the municipal services required of it by the City Charter; determine whether it establishes a budget each fiscal year that anticipates the expenditures for those mandated services and the revenue necessary to fund them from a reasonable level of taxation, state aid, and other funds; and determine <u>whether the City is paying its debts as they become due</u> and is doing so without stress.[167]

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[164] 21 June 2002 minutes of SDCERS Board meetings p. 16.

[165] 21 June 2002 minutes of SDCERS Board meetings p. 16. See n. 164.

[166] 21 June 2002 minutes of SDCERS Board meetings pp. 119-20. See n. 164.

[167] 19 September 1996 letter from Dwight A. Hamilton to Lawrence B. Grissom p. 4.

The City of San Diego was clearly not intending to pay its debts to the pension plan as they became due. This after-the-fact letter underscored the complete break down in the administration of the City's pension plan and the failure of Mr. Hamilton to meet his legal duties to the board and to participants in a timely manner. The the board conduct financial due diligence should have been given before the pension board approved MP-1 on 21 June 2002.

On 25 June 1996, the San Diego City Council held a closed session. Minutes of that meeting indicate that the meeting "halted at 9:41 a.m. Council continued with Meet and Confer Issues."[168] The closed session agenda indicates that the seventh item to be discussed was "Meet and Confer." A 21 June 1996 closed session memorandum from the City Attorney to the City Clerk identifies item three "Conference with Labor Negotiator, pursuant to Govt Code § 54957.6." The City's negotiators were identified as "Jack McGrory, Bruce Herring, Cathy Lexin, and Bill Lopez."[169]

On 28 June 1996, City Manager Jack McGrory sent a memorandum entitled "Retirement Summary" to the Mayor and City Council. According to the memorandum, "Attached is a summary of the Retirement proposal that you requested last week." A hand-written note indicates that the docket coordinator distributed the memorandum on 1 July 1996, at 1:30 pm. The attachments to the memorandum were (1) June 28 Retirement Summary; (2) June Modifications Proposal; (3) June 7 Retirement Proposal; (4) CERS Fiduciary Counsel Opinion.[170]

The 28 June 1996 retirement summary was identified as "San Diego City Employee Retirement System (SDCERS) Proposal identified and discussed above."[171] The Mayor and Council members receiving this one-page document were informed of the "Benefit Changes," the "Rate Stabilization" program, and the "Process" followed to secure approval of MP-1.[172] The document dated 21 June 1996, entitled "Modifications to Retirement System Proposal Dated June 7 1996," provided that changes were made to MP-1 "[a]s a result of issues raised by Dwight Hamilton, Fiduciary Counsel to the CERS

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[168] 25 June 1996 San Diego City Council closed session minutes p. 2.

[169] 21 June 1996 Memorandum "Closed Session Agenda Items for June 25, 1996." The memorandum was signed by Deputy City Attorney John M. Kaheny.

[170] 28 June 1996 Memorandum from City Manager Jack McGrory to Mayor and City Council re: "Retirement with four attachments."

[171] The Council and Mayor were provided with the 7 June 1996 MP-1 proposal at the 25 June 1996 closed session, where it was handed out to those in attendance. 7 June 1996 City Employees Retirement System Proposal, with handwritten note "Handed Out @ Closed Session 6/25/96."

[172] 28 June 1996 Memorandum from City Manager Jack McGrory to Mayor and City Council attachment "San Diego City Employee Retirement System (SDCERS) Proposal." See n. 170.

Board."[173] The final attachment to Mr. McGrory's 28 June 1996 memorandum was Mr. Hamilton's 21 June 1996 letter approving MP-1, which was discussed in detail above. The letter described the balloon payment that would be made if the funded ratio of the pension plan fell below 10% of the funded ratio calculated on 30 June 1996:

> In the event that the funded ratio of the System falls to a level ten percent below the funded ratio calculated in the June 30, 1996, actuarial valuation, the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated by an amount, determined by the actuary, that is necessary to restore the funded ratio to the proper level.[174]

However, Mr. Hamilton's letter is ambiguous on the question of the proper amount. Despite being put on notice, he failed to provide any legal advice in the 21 June 1996 opinion letter that the Council or the SDCERS Board should evaluate the practical ability of the City to pay what the trigger would require.

It is interesting to recall that during the 11 June 1996 workshop discussed above, Mr. Roeder had estimated that a 15% drop would cost the City $225 million. And when the trigger was hit in 2002, after the pension's funded ratio dropped below 82.3% (more than 10% below the 1996 funded ratio of 92.3%), a dispute arose over the amount that the City was required to contribute to the pension plan

On 25 June 1996, the City Manager had requested that the MP-1 item, scheduled for that session, be continued "for further discussion."[175] The closed session minutes for 2 July 1996 indicate that the recorder was excused from the closed session meeting.

The closed session agenda states "2. Meet and Confer." The Closed Session memorandum signed by Deputy City Attorney John M. Kaheny indicates that the second item to be discussed was closed session and identified the City's labor negotiators as Jack McGrory, Bruce Herring, Cathy Lexin, and Bill Lopez.[176] The supplemental docket "Adoption Agenda" identified item 500 for the 2 July 1996 public meeting of the City Council to be the fiscal year 1998 labor contract extensions. A consent motion was made by Council Member Valerie Stallings to adopt the resolution approving MP-1. The vote was unanimous:

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[173] 28 June 1996 Memorandum from City Manager Jack McGrory to Mayor and City Council attachment, 21 June 1996 memorandum entitled "Modifications to Retirement System Proposal Dated June 7, 1996." See n. 170.

[174] 21 June 1996 letter from Dwight Hamilton to SDCERS Administrator Lawrence Grissom purporting to approve MP-1 p. 3. See n. 159.

[175] 25 June 1996 Continued Item request form related to Item 208.

[176] See 25 June 1996 Closed Session minutes of the San Diego City Council. See n. 168; 2 July 1996 Closed Session Agenda, and the 27 June 1996 Closed Session memorandum regarding the Closed Session Agenda Items for July 2, 1996.

> CONSENT MOTION BY STALLINGS TO ADOPT RESOLUTION (R-287582) Second by Stevens. Passed by the following vote: Mathis-yea, Wear-yea, Kehoe-yea, Stevens-yea, Warden-yea, Stallings-yea, McCarty-yea, Vargas-yea, Mayor Golding-yea.[177]

Because MP-1 was approved by consent, the public was not provided a clear warning of the dangers that it threatened to the City's fiscal integrity. It would be eight years before any meaningful public discussion of MP-1 occurred, and that discussion was prompted by an investigation of City and pension officials, the loss of the City's credit rating, and the inability of the City, over the course of three years, to issue financial statements free of material error.

A 23 July 1996 memorandum from Cathy Lexin, the City's labor relations manager, to pension plan administrator Lawrence Grissom, entitled "City Manager's Retirement Proposal," set forth the "final Retirement Proposal as presented to the Retirement Board at its meeting of June 21, 1996." Subsequently, at its 2 July 1996 meeting, this proposal was presented to and approved by the City Council.[178] The 23 July 1996 memorandum from Cathy Lexin describing the final version of MP-1 reflected an additional change in the adjustments that would be made if the below-10%-of-the-1996-funded-ratio provision was triggered by the funded ratio dropping below 82.3%. According to the 23 July 1996 Lexin memo, in the event the 82.3% trigger point was reached, the following would occur:

> The City will pay the agreed-to rates shown above for FY 96 through 2007. In the event that the funded ratio of the System falls to a level 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation which will include the impact of the benefit improvements included in this Proposal, the City-paid rate will be increased on July 1 of the year following the date of the actuarial valuation in which the shortfall in funded ratio is calculated. The increase in the City-paid rate will be the amount determined by the actuary to restore a funded ratio no more than the level that is 10% below the funded ratio calculated at the June 30, 1996 actuarial valuation.

The parties failed to make the agreement precise enough to determine the exact remedy that would follow should the 82.3% trigger point be reached. The failure to make the consequence of a trigger event precise underscored the real objective of MP-1 to -- increase benefit liabilities beyond available same-year revenues and make the next generation pay for those benefits from later-year funding sources. As will be explained subsequently, this feature of MP-1 grossly violated the liability limit provisions of Charter § 99.

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[177] 2 July 1996 San Diego City Council Meeting Minutes pp. 1, 21-22.

[178] 23 July 1996 Memorandum from Cathy Lexin to Lawrence Grissom regarding the approval of the final version of MP-1; see fn. 2.

In a 31 July 1996 internal memorandum, the City pension plan administrator made clear that the MP-1 costs provided to the pension board and City Council were only "projections": "We must remember that the projections of increased liability resulting from the implementation of the Proposal are only projections and that the actual numbers for any given year may be higher or lower."[179]

This memorandum also stated that the actuary would track liabilities to the pension system caused by MP-1:

> The actuary will track the liabilities associated with the Proposal separately from other System liabilities and make recommendations as part of each annual actuarial valuation of an amount to transfer from the Reserve for Proposed Retirement Changes to the Employer year.[180]

As was found by the City's outside disclosure practices lawyers, the use of reserve funds to pay for the costs of MP-1 made no financial sense:

> In application, however, this approach would have had no practical effect on SDCERS' funding. Whenever surplus earnings are diverted to a reserve held outside System assets, the result is a dollar-for-dollar reduction to the Employer Contribution Reserve (which receives all amounts not allocated to other uses). Under this proposal, surplus earnings placed in the Earnings Stabilization Reserve would be bled annually into the Employer Contribution Reserve in amounts equal to the contribution shortfall. Upon the exhaustion of the Earnings Stabilization Reserve, the balance of the Employer Contribution Reserve would be essentially the same as if there had there been no intervening transfers. In no sense would this process compensate the System for the contribution shortfalls contemplated in MP1.[181]
>
> ***
>
> The error in this approach lies in the mistaken idea that assigning previously unallocated surplus earnings to the Employer Contribution Reserve could effectively offset the contributions lost as a result of Manager's Proposal 1. Much like the idea, previously considered and discarded, that the shortfall could be erased by allocating surplus earnings into an account held outside System assets, then, over time, transferring them back again, this approach accomplished nothing of practical value.[182]

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[179] 31 July 1996 memorandum from Lawrence Grissom to Business Procedures Committee p. 2.

[180] 31 July 1996 memorandum from Lawrence Grissom to Business Procedures Committee p. 2. See n. 179.

[181] 16 September 2004 Report pp. 52-53. See City of San Diego Website.

[182] 16 September 2004 Report pp. 53-54. See City of San Diego Website.

Running previously "unallocated" excess earnings through a special reserve account before booking them into the same "inside" account to which they otherwise would have gone directly does not affect System funding levels or employer contribution rates. It resolves itself into accounting entries that ultimately cancel out. The approach outlined in MP1 was, in fact, never followed.[183]

The Earnings Stabilization Reserve – containing $10.7 million in FY 1994 surplus earnings – was closed into the Employer Contribution Reserve at June 30, 1996, rather than being applied as described in the Manager's proposal. According to SDCERS administrator Lawrence Grissom this was done because the Board found that its lacked authority under the Municipal Code to use the funds as proposed. The attempt to use FY 1995 and 1996 surplus earnings to provide contribution relief to the City also proved futile. In FY 1996, $144.3 million was taken from FY 1995 and 1996 surplus earnings and placed in a "Proposed Retirement Changes Reserve," in anticipation of the implementation of MP1.[184]

In FY 1997, $82.5 million of this amount was credited to a Reserve for Retirement Changes (City)" and $4.3 million to a "Reserve for Retirement Changes (Port District)." Another $3.5 million from the Proposed Retirement Changes Reserve was transferred to a newly created 13th Check Reserve, to provide a back-up source of payment for the benefit arising from the *Andrews* litigation. The remaining balance of approximately $53.6 million was folded into the Employer Contribution Reserve, where it would have gone initially had it not been diverted into the Proposed Retirement Changes Reserve.[185]

This amount appears to correspond to the portion of the Proposed Retirement Changes reserve derived from FY 1995 excess earnings. This $87 million in the City and Port Reserves for Retirement Changes, the only funds purportedly dedicated to offset the funding shortfall created by MP1, was then left dormant, with no crediting of interest or additional allocations from earnings, and no withdrawals to "fund" the contribution shortfall in the years following the adoption of the Manager's proposal. As mentioned, because these funds were held inside SDCERS assets, their allocation into designated accounts had minimal effect on the System's funding ratio.[186]

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[183] 16 September 2004 Report p. 54. See City of San Diego Website.

[184] 16 September 2004 Report p. 54. See City of San Diego Website.

[185] 16 September 2004 Report p. 54. See City of San Diego Website.

[186] 16 September 2004 Report p. 54. See City of San Diego Website.

> According to Mr. Grissom, nothing was done with these reserves because, again, SDCERS found it had no authority under the Municipal Code to dispense them for their designated purpose and, in addition, because he and others concluded that shifting funds from one inside account to another accomplished no more than moving "money from the left pocket to the right."[187]

On 10 October 1996, Dwight Hamilton's 19 September 1996 opinion to the SDCERS Board was provided "to Mayor & Council only, not full distribution. Bcc: Ed Ryan Pat Frazier."[188] Written at the behest of Ann Parode, this opinion indicated that the pension board had a duty "to determine the ability of the borrower" (the City) to pay the underfunding as required in MP-1. The pension board never fulfilled its duty to check into the City's financial ability to make a balloon payment in the amount of hundreds of millions of dollars. At the 20 December 1996 SDCERS Board meeting, there was a brief discussion of the issue.[189]

As of 18 December 1996, MP-1 was not yet fully implemented according to a memorandum from Jack McGrory to Keith Enerson relating to "Implementation Schedule for Manager's Proposal.[190] Mr. McGrory suggested that full implementation be pushed back to after the SDCERS target date of 27 January 1996.[191] In the memorandum Mr. McGrory admitted that he was a plan fiduciary:

> I am concerned that if we push to achieve implementation at too early a date, something could be overlooked. Part of the fiduciary duty to the members and beneficiaries of the System which we all share is to insure that benefits are accurately and equitably defined and properly administered.[192]

According to a SDCERS Bulletin dated April 1997, the SDCERS plan participants' final vote on MP-1 was held from Friday, 4 April 1997, through Sunday, 13 April 1997.[193] The SDCERS bulletin that was addressed to plan participants contained

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[187] 16 September 2004 Report pp. 54-55. See City of San Diego Website.

[188] 10 October 1996 memorandum from Jack McGrory to Mayor and City Council regarding Legal Opinionfrom CERS Fiduciary Counsel.

[189] 20 December 1996 SDCERS Board Minutes pp. 11-12.

[190] 19 December 1996 Memorandum from Jack McGrory to Keith Enerson at the SDCERS Retirement Board.

[191] 19 December 1996 memorandum from Jack McGrory to Keith Enerson at the SDCERS Retirement Board. See n. 190.

[192] 19 December 1996 memorandum from Jack McGrory to Keith Enerson at the SDCERS Retirement Board. See n. 190.

[193] SDCERS Bulletin "BENEFITS ELECTION" April 1997.

false and material misrepresentations and misleading statements. The bulletin asserted that the SDCERS fiduciary counsel had approved the proposal. However, it did not disclose the fact that the fiduciary counsel had also advised the pension board to determine "the ability of the City to provide the funds" to pay the costs of MP-1. In addition, the bulletin did not disclose that the pension board had failed to determine whether the City had the practical ability to pay the balloon payment required by the 82.3% trigger provision. When the trigger was hit in 2002, those payments would exceed $500 million dollars.[194]

The SDCERS bulletin falsely stated that the proposal "includes a provision to assure the funding level of the system will not drop below a level the Board's actuary deems reasonable in order to protect the financial integrity of the Retirement System." MP-1 provided that if the funding level dropped, the City would have at least until 2009 to make good unless the level dropped more than 10% below the 1996 funding ratio of 82.3%. Again, the bulletin did not disclose that the City would not have the practical ability to make funding contributions needed to keep the system at 82.3%. (Currently, the funding level is 27.3% below the 1996 funding ratio of 92.3%.)

Further, the SDCERS bulletin did not disclose that, in possible violation of California Government Code § 1090, board members agreed to the proposal while they held interests in the contract creating collective bargaining improvements provisions. The SDCERS bulletin also did not disclose that the duty to fund the new pension benefits was created in likely violation of San Diego Charter § 99, which prohibits the debt undertaken by the City to pay the benefits, and that the quid pro quo agreement was entered into to help the City's budget priorities and was likely an illegal and unenforceable contract.

The SDCERS bulletin falsely stated that MP-1's five-year-purchase-of-service provision would be funded with payments from employees that would "make the system whole for such time." A 24 February 1997 MEA PUL (Pass Up the Line) noted that the cost of the pension service credits had not been set and explained how it would be established:

> The Retirement Board based on the advice of their actuary has the task of setting the employee cost of the Purchase of Service Credit (buy back) changes. The cost will be calculated by taking the percentage price the Retirement Board sets and multiplying it times your annual salary. (**For example: If the cost were 15% and you earn $30,000.00 per year,** [15% x 30,000.00] **would equal $4,500.00 for each year you wish to purchase.)**

The pension board has not taken effective action to recapture the losses caused by the underpricing of this program. The plan participants approved MP-1, and the plan was

[194] See San Diego City Attorney Interim Report II; see San Diego City Attorney Website.

implemented by the City Council in March 1997.[195] Approximately 2,900 of the 18,000 plan participants bought more than 13,000 pension year credits at a discount that cost the system more than $100 million in underfunding.[196]

There has been extensive speculation about why City Manager Jack McGrory, City pension plan administrator Lawrence Grissom, Mayor Susan Golding, and the City Council created MP-1. The City's motivation was clearly to find money to spend on other priorities. An 11 October 1996 letter from Mr. McGrory to John Gibson, Director of the Reports & Analysis Division of the Federal Election Commission, stated that the City of San Diego had spent $6,473,032 on the Republican Convention.[197] The 28 May 1996 closed session writing stated that the alternative to adopting MP-1 would be a reduction in the 1997 fiscal year budget of $8.66 million.[198]

The San Diego City Charter and the California State Constitution limit municipal power to create liabilities.[199] The liability limit contained in San Diego City Charter § 99 is "meant to establish the 'pay-as-you-go' principle as a cardinal rule of municipal finance." *Westbrook v. Mihaly* 2 Cal. 3d 765, 776 (1970); *San Francisco Gas Co. v. Brickwedel* 62 Ca. 641 (1882). The "underlying philosophy of § 99 in its current form is to prevent City officials from mortgaging future revenues for present benefits." That objective is also reached by a similar liability limit clause in the California State Constitution.[200] Charter liability limit clauses, like San Diego Charter § 99, mandate "that each year's income and revenue must pay each year's indebtedness and liability, and that no indebtedness or liability incurred in any one year shall be paid out of the income or revenue of any future year." *San Francisco Gas Co. v. Henery Brickwedel* 62 Cal. 641, 642 (1882).

As was pointed out by pension board members John Casey and Ann Parode, MP-1 created liabilities in years that exceeded those years' revenues. MP-1 pushed the

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[195] MP-1 was implemented in a series of City Council meetings during March 1997.

[196] See San Diego City Attorney Interim Report II. See City Attorney's Website, and 2004 SDCERS Actuarial Valuation. See also n. 91.

[197] 11 October 1996 letter from City Manager Jack McGrory to John Gibson, Director Reports and Analysis Division, Federal Election Commission ("City of San Diego Expenditures" attachment).

[198] 28 May 1996 Closed Session Meet and Confer documents, p. 2. See n. 111.

[199] San Diego City Charter § 99. See n. 3; California State Constitution Art. XVI § 18, and n. 1. This part of the report presents a legal analysis that shows MP-1 is void. The San Diego City Attorney's Interim Report 3 analyzed other provisions of law that require MP-1 to be set aside. The analysis here also would apply to MP-2, the add-on contract created by the pension board and City Council in 2002. The legal basis for setting aside MP-1 offered in the City Attorney's Interim reports does not exhaust all options that the City has for setting aside MP-1 and MP-2.

[200] The liability limit clause in the California State Constitution Article II § 18 discussed in the San Diego City Attorney Opinion was moved to Article XVI § 18. City Attorney City of San Diego Opinion (18 March 1968) *City Charter § 99-Continuing Contracts* p. 2.

unpaid liabilities into future years and onto the next generation.[201] Because the MP-1 contract was created in violation of the liability limits of San Diego Charter § 99, MP-1 is void. Again, under San Diego Charter § 99 each year's revenue must pay each year's indebtedness, and no indebtedness incurred in any one year may be paid out of the revenue of any future year. *Tehama County v. Sisson* 152 Cal. 167 (1907). In 1996 and 1997, the City was unable to incur the MP-1 liabilities because they had to be paid from the revenues of subsequent years. *Bradford v. City and County of San Francisco* 112 Cal. 537 (1896).

By requiring City officials to limit the City's liabilities to its same year revenues, San Diego Charter § 99 enshrines the pay-as-you-go mandate for financing City services:

> The City shall not incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year unless the qualified electors of the City, voting at election to be held for that purpose, have indicated their asset as then required by the Constitution of the State of California, nor unless before or at the time of incurring such indebtedness provision shall be made for the collection of an annual tax sufficient to pay the interests on such indebtedness as it falls due.

In 1968 the voters amended San Diego Charter § 99 to bring it into conformity with a similar provision in the California State Constitution (Article XVI § 18). Former City Attorney Ed Butler explained that the intent behind the amendment was "to bring our Charter into conformity with the protections afforded by the State Constitution."[202] Article XVI §18 of the California State Constitution requires a 2/3 vote of the electorate before liabilities exceeding revenue in the same year may be incurred:

> No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose … .[203]

Under the debt limit language in San Diego Charter § 99 and California Sate Constitution Article XVI § 18, the San Diego City Council may incur liabilities that exceed same year revenues only after an election. The election mode becomes the measure of the City's power to incur any liability beyond the limit fixed by Charter § 99.

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[201] See Minutes of 11 June 1996 SDCERS board workshop. N. 129; 21 June 1996 minutes of 21 June 1996 SDCERS board; 20 December 1996 SDCERS board, n. 189; 31 July 1996 memorandum from pension fund administrator Lawrence Grissom. N. 179.

[202] Argument For Proposition A Signed by San Diego City Attorney Ed Butler. Proposition A was adopted by the voters at the 1968 Primary Election.

[203] Article XVI § 18 (a) of the California State Constitution. See n. 1.

City of San Ta Cruz v. Wykes, 202 F. 357 (1913). When a City's power to make a contract is statutorily limited to a certain prescribed method and a contract is created in violation of the prescribed method, the contract is void:

> [T]he contract is void because the statute prescribes the only method in which a valid contract can be made, and the adoption of the prescribed mode is a jurisdictional prerequisite to the exercise of the power to contract at all and can be exercised in no other manner so as to incur any liability on the part of municipality. Where the statute prescribes the only mode by which the power to contract shall be exercised the *mode* is the *measure* of the power. A contract made otherwise than as so prescribed is not binding or obligatory as a contract and the doctrine of implied liability has no application in such cases. *Reams v. Cooley*, 171 Cal. 150, 154 (1915).

Because of San Diego Charter § 99, the City Council was without power to incur the pension liabilities caused by MP-1:

> Here, neither the officers of the corporation nor the corporation, by any of the agencies through which they act, have any power to create the obligation to pay for the work, except in the mode which is expressly prescribed in the charter; and the law never implies an obligation to do that which it forbids the party to agree to do. *Reams v. Cooley*, 171 Cal. 150, 155 (1915) (quoting from *Brady v. Mayor etc. of New York*, 16 How. Pr. 432).

The San Diego City Charter operates not as a grant of power but rather as an instrument of limitation and restriction on the exercise of power over all municipal affairs that the City is assumed to posses. Any contract made without regard to the Charter's limitations and restrictions is void and unenforceable. *Domar Electric, Ind. v. City of Los Angeles*, 9 Cal. 4th 161, 171 (1994); *Miller v. McKinnon*, 20 Cal. 2d 83, 88 (1942); *Reams v. Cooley*, 171 Cal. 150, 153-154 (1915); *Howard Jarvis Taxpayers Assn. v. City of Roseville*, 106 Cal. App. 4th 1178, 1186 (2003).

Because in adopting MP-1, the City Council incurred liabilities that exceeded revenues for that and later years, the City Council's action was *ultra vires* -- that is, beyond the scope or in excess of City Council's legal power or authority.[204] An *ultra vires* act is one "performed without any authority to act.… [An] *ultra vires* act of a municipality is one which is beyond powers conferred upon it by law." Black's Law Dictionary 1522 (6th ed.1990). The MP-1 contract created liabilities above same year revenues and was wholly beyond the powers of a municipality. MP-1 is therefore void. *Los Angeles Dredging Co. v. City of Long Beach,* 210 Cal. 348, 353 (1930); see also *Thomas v. City of Richmond,* 79 U.S. (12 Wall.) 349 (1870).

[204] Webster's Third International Dictionary.

Because those contracting with a municipality are presumed to know the extent of its authority with regard to constitutional municipal debt limitation, all who act contrary to those limitations must bear the risk of a shortfall in the current year's revenues. *Law Offices of Cary S. Lapidus v. City of Waco*, 114 Cal. App. 4th 1361 (2004). All parties contracting with the City are required to ensure that liability contracts are made in compliance with the Charter:

> It may sometimes seem a hardship upon a contractor that all compensation for work done, etc., should be denied him; but it should be remembered that he, no less than the officers of the corporation, when he deals in a matter expressly provided for in the charter, is bound to see to it that the charter is complied with. If he neglect this, or choose to take the hazard, he is a mere volunteer, and suffers only what he ought to have anticipated. If the statute forbids the contract which he has made, he knows it, or ought to know it, before he places his money or services at hazard. *Reams v. Cooley*, 171 Cal. 150, 157 (1915).

Those claiming benefits under MP-1 are presumed to have known that MP-1 was created in violation of Charter § 99's liability limits, and therefore they have no means of obtaining payment. *Weaver v. City and County of San Francisco*, 111 Cal. 319 (1986). The MP-1 claimants' ignorance of the law is no excuse: "A party engaging in business relationships with a municipality is presumed to know the law including the procedures necessary to enter into a binding contract." See *Miller v. McKinnon*, 20 Cal. 80, 83 (1942); *Seymour v. State*, 156 Cal. App. 3d 200, 205 (1984).

The framers of the California State Constitution placed the liability limits into the State Constitution to avoid floating indebtedness:

> The system previously prevailing in some of the municipalities of the State by which liabilities and indebtedness were incurred by them far in excess of their income and revenue for the year in which the same were contracted, thus creating a floating indebtedness which had to paid out of the income and revenue of future years, and which, in turn, necessitated the carrying forward of other indebtedness, was a fruitful source of municipal extravagance. The evil consequences of that system had been felt by the people at home and witnessed elsewhere. It was to put a stop to all of that, that the constitutional provision in question was adopted. *San Francisco Gas Co., v. Brickwedel*, 62 Cal. 641, 642 (1882).

Obviously, enforcing the Charter's liability limit would work a major change in favor of disciplining the City's fiscal practices:

> Payment not only goes hand in hand with expenditure, but wasteful expenditures, instead of being concealed or mitigated by delay of payment or the creation of debts, must be immediately made known to the people, through the demands of the tax-gatherer for money. This system is

> wholesome in this effect upon those who control and can squander the taxes. They are made sensible that their delinquencies will be known by being immediately felt by their constituents. It is wholesome in its effect upon the people. Their self interest is provoked to prompt scrutiny into conduct of their public agents. *State v. Medbery*, 7 Ohio St. 522, 541 (1857); *Controlling Legislative Shortsightedness*: *The Effectiveness of Constitutional Debt Limitations*, 1991 Wis. L. Rev. 1301, 1134.

A City can violate the constitutional municipal debt limitation by incurring even a very small debt if the City's other obligations during that year have already exhausted the City's total revenues for the year. *Law Offices of Cary S. Lapidus v. City of Wasco*, 114 Cal. App. 4th 1361 (2004). In San Diego the pension board and the City Council have created a massive liability and have passed that unpaid liability on to the next generation. Those who claim MP-1 as their defense may not be heard because they are required always to comply with the liability limit provisions of the Charter, and they did not do so. MP-1 is void. Although this finding might be considered radical, it is what the law requires:

> We have neither the right nor the disposition, by judicial interpretation, to take away the wholesome restriction upon municipalities thus imposed by the Constitution. Of course, in giving effect to this radical change from the pre-existing condition of things, it will not be strange if some shall be found to suffer. But it must be remembered that all are presumed to know the law, and that whoever deals with a municipality is bound to know the extent of its powers. Those who contract with it, or furnish supplies, do so with reference to the law, and must see that limit is not exceeded. With proper care on their part and on the part of the representatives of the municipality, there is no danger of loss. *San Francisco Gas Co. v. Brickwedel*, 62 Cal. 641, 643 (1882).

CONCLUSION

The City of San Diego has suffered irreparable injury because elected and appointed officials failed to comply with the liability limit laws of the California Constitution Article XVI § 18 and the San Diego Charter § 99. The illegal liabilities that they created in the pension plan that many of them shared in must be set aside under these and other provisions of law previously identified in the City Attorney's other Interim Reports.

By_____
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